EXPORT POLICY

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

PART 3

FOREIGN GOVERNMENT POLICIES AND PROGRAMS TO SUPPORT EXPORTS

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CONTENTS

THURSDAY, MARCH 9, 1978

FOREIGN GOVERNMENT POLICIES AND PROGRAMS TO SUPPORT EXPORTS[1]

THURSDAY, MARCH 9, 1978

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON INTERNATIONAL FINANCE,
Washington, D.C.

The subcommittee met at 9:30 a.m. in room 4232, Dirksen Senate Office Building, Senator Adlai E. Stevenson, chairman of the subcommittee, presiding.

Present: Senators Stevenson and Heinz.

OPENING STATEMENT OF SENATOR STEVENSON

Senator STEVENSON. Today the Subcommittee on International Finance continues oversight hearings on U.S. export policy.

On February 23d, the subcommittee heard testimony concerning shifts in the composition of U.S. exports. Witnesses pointed to declining research and development expenditures and lagging investment and productivity as threats to the competitiveness of U.S. exports which cannot be remedied by a sinking dollar.

The implications to date are clear; notwithstanding a sinking dollar, the United States will suffer at the hands of more efficient and technologically advanced competition in the world, and even in its national markets, unless there are some changes.

This morning we will hear testimony on the policies of foreign countries to promote exports. World markets have become highly competitive as nations have become more dependent on export earnings to finance energy imports and maintain internal production and employment goals. We hear of methods by foreign governments to support exports and curb imports to the detriment of U.S. competitors. Yet, I know of no comprehensive U.S. study of what the world is doing.

We must know what the competition is and how to beat it. And I hope American ingenuity is capable of suggesting something more than subsidies, quotes, and tariffs.

Officials from the Commerce and State Departments, and Chairman Moore of the Eximbank will help us explore this subject this morning.

Senator Heinz has an opening statement.

[1] This is part 3 of an eight-part series of hearings on U.S. export performance and export policy. The hearings form part of a subcommittee study which will serve as a basis for recommending action needed to insure the competitiveness of U.S. agriculture and industry in world markets.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, the subject we address today, the policies and programs offered by other major trading nations to support their exports, is vitally important to our economic well-being, especially in light of our substantial trade deficit. We must obtain a more thorough understanding of our competition if we are to be successful in implementing appropriate measures to improve our export performance and maintain the future competiveness of U.S. exports in the world markets.

At present, there appears to be a general consensus that our major trading competitors offer greater assistance and better incentives to their exporters than we do to our own. A primary reason given for this situation is that exports are more important economically to these nations because they constitute a much larger percentage of their GNP's—between 15 to 30 percent—than of ours—approximately 8 percent.

As a result, statistics show that our competitors have spent significantly more money on export promotion—up to eight times as much—and have supported a substantially larger percentage of their exports with official credit—up to four times as much—than we have done in the past.

Furthermore, export financial assistance offered by our competitors goes far beyond what we offer. Mixed credits, foreign content financing, inflation and exchange rate fluctuation insurance, and large credit lines, available for extended periods, are all financing mechanisms offered by one or more of our trading competitors for which we have no counterparts.

Tax incentives are another area in which we do not appear to be competitive. A study conducted by the Special Committee for U.S. Exports reveals that other nations' tax practices significantly improve the price competitiveness and profitability of their exports. Our major tax incentive, the DISC program, did not compare favorably.

We have attempted in bilateral and multilateral trade negotiations to reach agreements to reduce or standardize export support programs, but these attempts have met with limited success.

Though we should continue our efforts in this area, we must also reassess our export programs and policies in light of the competition and consider appropriate changes to meet this competition.

Therefore, I hope our witnesses today will give us a better understanding of the export programs and policies of our competitors and of possible new programs and policies which we may implement to meet the challenge and improve our export performance and competitiveness.

Senator STEVENSON. Well, it looks like we may have to appropriate your tape recorder.

Mr. WEIL. All right, Mr. Chairman, but it's Japanese-made.

Senator STEVENSON. Well, we're going to have an American reporter after all.

Senator STEVENSON. Let me suggest to all of the witnesses this morning that if at all possible they summarize their statements in order to save some time, and if so, the full statements will be entered in the record. Please proceed, Mr. Weil.

STATEMENT OF FRANK A. WEIL, ASSISTANT SECRETARY FOR INDUSTRY AND TRADE; ACCOMPANIED BY JON MENES, VINCENT TRAVAGLINI, AND ANDREW STOLAR, DEPARTMENT OF COMMERCE

Mr. WEIL. Mr. Chairman, I'm glad to be back today. The line between the testimony that I gave on February 23d and the subject today is rather indistinct. I hope that I will not repeat anything covered last time.

I will simply go lightly over the highlights of this 31-page statement rather than read it into the record, and I appreciate your taking it for the record.

I would like to get as quickly as possible to your questions.

To begin, I want to make an observation which has to do with data. I would have liked—and I know you would have liked—to have been here today with charts, tables, and very precise information. But let me say at the outset that having pressed hard for such information, I can say that it really is essentially impossible because we are talking about noncomparables. We have been able to evaluate the situation and are able to give judgments, but what is done in one country differs from others, and there is no precise pattern by which one can measure quantitatively what is done in the various countries around the world. One can only gather together generalized information and comment, which we have done.

Senator STEVENSON. You're talking about export supports?

Mr. WEIL. Yes. Comparing the export environment in different countries is very difficult to quantify. I would like to think that we could. There have been many studies made. We continue to update some of the historical studies, but to give it to you in precise, quantitative comparable terms is something that I don't think would be feasible. Still, we can draw some conclusions.

To begin, I think it's important to recognize that whatever we do and whatever other countries have done in the past with respect to export promotion and development is something which has an effect only in the longer run, and only if whatever is done is sustained. I think it is quite clear, and I think I commented the last time I testified, that one of the fundamental reasons why some of our competitors in the world are exporting more effectively than we are is that exports have been more important to them for a long time. For such varied reasons as insufficient raw materials and/or small domestic markets these countries have turned to exports to support their economies. They have created very positive export environments in their countries and have maintained those environments over a longer term. We have only fairly recently come into a situation where imports have been that important to us, thus necessitating exports. Consequently, the environment that this country has created for exporters has been different. I think that that is the thrust of your hearings here.

As a consequence of that, and the fact that we have this large market in the United States which is satisfying most American firms, there is a fairly weak orientation on the part of most of our businesses toward exports. The converse is true in other parts of the world where, as I think I testified earlier, there's great need on the part of businesses in foreign countries to immediately look to foreign markets. There is a strong export orientation. However, governments can only help facilitate, create an environment, positive or negative. They cannot create that orientation. So that one of the things we have to try to do is create an environment in which that orientation will develop.

Let me talk briefly, Mr. Chairman, about the policies that are followed by foreign governments. It has been suggested that broad monetary and fiscal policies of competitor nations are significant in their export relationship to us. I think that that is probably an exaggeration. There is probably less relationship between what foreign countries do in terms of their own internal fiscal and monetary policies and their export environment. It would appear that the effect of those policies on their export performance is a good deal less than the other things they do to create an export environment.

On the other hand, we have found that what they do in terms of targeting of export industries, such as the targeting of regional assistance to certain types of industries, can be very important to their export performance. There is considerable evidence in Japan, for example, that the cooperation between the Government and industry in targeting opportunities and in developing abilities to meet those opportunities has been very important.

Another subject which I know has been of interest to your committee is the performance of the United States in terms of research and development. This is a long-term problem. There is still considerable research and development expenditure in this country, although there is some evidence that we have slipped in relation to the rest of the world, in particular, that the share of our GNP that goes to research and development has shrunk over the last decade from 3 percent to just a little over 2 percent. I don't think we should be as concerned about the fact that our competitors' research and development are growing as much as we should be concerned that ours is not keeping pace. We must also remember that research and development in other parts of the world can be of benefit to this country as well.

There has also been concern that our foreign competitors have made more exemptions from certain types of environmental or antitrust regulations to assist their export industries. We have found on examination that the exemptions are probably less relevent to the assistance of the export industries than the fact that the general climate in those countries with respect to antitrust law is different to begin with.

Let me move on quickly to the financial incentives that are offered. They are as varied as human ingenuity would suggest. There are unquestionably more financial incentives through tax systems and loan arrangements in foreign countries than in this country. It's very difficult for us to evaluate which of the types of incentives that are used abroad would be of value here because, as I indicated at the outset, the appropriateness of any given kind of set of incentives is a function of the cultural and economic history of that given country. I think that we have to be careful not to look at one kind of incentive in one country and immediately assume that it would work here.

There is concern that the use of the value added tax—VAT—which is remitted at the border of many Western European countries creates an opportunity for foreign exporters that is disadvantageous to ours.

There is no question that the European preference for indirect taxes shifts some of the tax burden away from the foreigner to the domestic consumer in those countries, but there is some question as to the degree of advantage that gives to foreign exporters. We, of course, remit our local sales taxes, which is a comparable thing, so the total advantage to the foreign buyer is unclear. It's very difficult to measure that.

In terms of supplemental nontax incentives involving export financing, such as mixed credits and local cost financing, there is again considerable evidence that there is more support available in foreign countries. Beyond export financing, about which Chairman Moore will testify, the United States offers little to exporters in the form of supplemental official support.

In the MTN it is our hope that we can get more concurrence on the control of tax incentives and subsidies for exports. Our position at the MTN is that the coverage of prohibitions on export subsidies should be expanded to include LDC's and exports of agricultural and primary products. We also need new controls over the use of domestic subsidies which have significant trade-distorting effects.

Quickly jumping ahead to our export promotion support, we do have a few numbers here. I'd like to qualify them by saying that numbers are very dangerous because the way in which the numbers are assembled in these countries vary. But in relative terms the United States spends only about $340 per million dollars of manufactured exports against around $600 for Japan. Italy spends $1,400; and England spends $2,500. Germany spends less according to these calculations—about $140—but there is some evidence that there are other means by which Germany supports its exporters.

In terms of the budget of the central government, the United States spends less than one one-hundredth of 1 percent of its budget on export promotion, while other trading nations average about six times as much, or six one-hundredths of 1 percent of the annual governmental budget.

I think part of the problem is the efficiency with which we use our resources. My personal feeling at this point is not that we need a great deal more resources, but that we need to use what we have more effectively. Our resources are scattered, but we are working hard at the moment on trying to get better cooperation among the State Department, Department of Commerce, the Treasury, and the other agencies such as the Eximbank. In the last 6 months my observation is there has been an improvement in the cooperation, and the prospects look promising.

What are we doing in the Department of Commerce to address this? Well, we are trying to shift some of our emphasis from our programs abroad to providing more opportunities at home for our exports. What exporters need in this country are customers. We need to facilitate getting our exporters into the right frame of mind, into an environment where it is advantageous for them to export, and then direct them to their customers.

We find that a lot of businessmen have looked for help, but they sometimes end up like a hunting dog rooting around and coming up with an old bone. We've got to be more effective. This is an objective that is on the top of my list. It is not easy to do, because we have in place programs that have been functioning for a number of years.

People's habits get engrained, but I think that, over a period of time we can have a more effective export development program.

We are working hard at getting better communication between the commercial missions overseas, our field offices in this country, and here in Washington.

This is only an overview, probably much too cursory to be of any great value, but the details substantiating these remarks are in my testimony.

Senator STEVENSON. Your full statement will be placed in the record, Mr. Weil. Thank you.

[Complete statement follows:]

STATEMENT OF FRANK A. WEIL, ASSISTANT SECRETARY OF COMMERCE FOR INDUSTRY AND TRADE

Mr. Chairman, I am pleased to appear before this Subcommittee again. Today's session gives me the opportunity to build upon the statements I made on February 23, when I focused on U.S. export performance. Today I would like to shift emphasis from the general U.S. export situation to a discussion of the export promotion and support activities in the other major trading nations and how these activities differ from our own approach. To this end, I plan to: provide an overview of the exporting environment in the major trading nations; discuss the role of general economic policies in encouraging exports; consider some of the more important financial incentives that countries make available for exporting purposes; and compare export promotion activities in other countries with those of the United States.

Finally, I would like to conclude my testimony by discussing our plans for the future of U.S. export promotion activities.

THE ENVIRONMENT FOR EXPORTING

The subject of today's hearings—government programs in support of exports—should not be viewed from a short-run perspective. For most countries, the export incentives and promotion programs which existed in the early 1970's continue today with relatively few changes, yet our trade has gone from a record surplus of $11.0 billion in 1975 to a record deficit of $26.7 billion last year, on a Census basis. As I and others have testified, the business cycle and oil imports are the major reasons for this change.

I raise this point because it is critical to dealing logically and effectively with our export promotion programs and incentives. We must view all such programs and incentives, both in the United States and foreign countries, not as instruments for dealing with short-run problems, but as mechanisms for insuring that long-term trade performance is optimal. The current deficit certainly gives emphasis to the need to address more forcefully the issue of encouraging U.S. exporters. However, the problems would still be there even if the current large deficit had never materialized. Thus, we must be prepared to act on a long-term and sustained basis if a real and lasting improvement is to be achieved.

To begin, let us look at the export environment in other major trading nations. The first and foremost point to be made is that exports are more important to the economic well-being of other nations than to the United States. Exports are roughly 6 percent of U.S. gross national product, while the average is about 19 percent—some three times as high—for the other six major trading nations (Germany, Japan, France, Italy, the United Kingdom, and Canada). Lacking either large domestic markets or abundant supplies of raw materials, other major nations long ago turned to exporting for economic growth and well-being. It is not inaccurate to state that their prosperity, and perhaps even their economic survival, depends upon their ability to export.

Export expansion is one of the top national priorities for the other major nations. They have geared their national policies and institutions to the needs of exporting. Their fiscal, monetary, industrial, and other policies are formulated in full recognition of their impact on the prospects for export growth.

Their government policies are usually developed to aid exporting and seldom, if ever, are permitted to retard export growth.

The Subcommittee has expressed a special interest in West Germany and Japan. These nations, together with the United States, are the world's leading trading nations—especially in the area of manufactured goods. Germany and Japan are not only major competitors of the United States in the world market place, they are—after Canada—our major trading partners.

In 1977 the U.S. had a record trade deficit while Japan recorded its largest and Germany its second-largest trade surplus in history. Casual observation might suggest that Japan and Germany have been successful in stimulating their exports, while the U.S. has failed. However, as we know, the main reason for the U.S. deficit and the others' surpluses is the business cycle. The United States has had impressive success in recovering from the recent recession which has given a strong boost to the exports of our trading partners, especially Japan. In contrast, recovery in Japan and Europe has lagged badly which has held down U.S. exports. However, there are clearly other factors at work besides cyclical ones in explaining the export performance of nations like Germany and Japan.

There does seem to be a special propensity toward exporting on the part of nations like Japan and Germany. Japan especially must trade for a living. The Japanese are an island nation with few resources, and their standard of living is highly dependent upon the imports they are able to buy with the foreign exchange earned from exports. The Germans, on the other hand, do a great deal of travelling outside of their borders and have a large amount of "guest workers" from other nations who send their earnings home. To pay these bills and to provide for imports, it has been estimated that more than 15 percent of German gross national product must be exported.

Business firms in other major nations tend to be much more export-oriented than U.S. firms. The export market is typically as important (in some cases more important) to the business community as the domestic market. Also, if their domestic markets stagnate, these firms will typically push their export sales. To some extent, the current strong export performance of Japan and Germany is due to their business firms' ability to turn to foreign sales when domestic markets become soft.

This strong commitment to exporting appears to be largely absent from the American scene, especially among small- and medium-sized firms. The explanation is simple and well-known. The United States is the world's largest single market. For most U.S. firms, the domestic market is all they are interested in—the foreign market seems impenetrable and, in many cases, exporting is considered more of a nuisance than an advantage. Understanding this fact is basic to developing what we must do in this area.

The other major trading nations take advantage of the export awareness of their business communities. They maintain extensive export promotion programs and have instituted many types of financial incentives to export. Even general macroeconomic and industrial policies are formulated with an awareness of their significance for the exporting environment.

These policies undoubtedly help business firms in exporting, but—and I want to emphasize this—these policies do not create the desire to export. Governments can make it easier and more attractive for companies to export, but the basic orientation to the export market must be already there.

GENERAL ECONOMIC POLICIES

At the broadest level, a government has available to it fiscal and monetary policies. Overall, such policies are of too general an impact to be utilized to promote exports. Nonetheless, such general economic policies do create conditions—credit availability, inflation, etc.—which can affect exports. The relatively moderate fiscal policies of Germany and Japan in 1975 and 1976, for example, while not conducive to domestic growth have been beneficial to price stability and in encouraging firms to look to overseas markets.

Industrial policy.—Industrial policy, on the other hand, is of greater direct significance from an export perspective. Industrial policy programs, such as regional development schemes, may be used to channel resources to industries with export potential, to encourage product diversification with an eye toward expanding exports, and to promote improvements in the quality and design of such goods.

The emphasis on industrial policy varies considerably among countries. Japan, France and Italy, for example, regard industrial policy as a major instrument for achieving clearly defined targets of industrial development. In these countries the objectives are usually formulated within the framework of economic and social development *plans*. On the other hand, countries such as the United States, Denmark, Sweden, and to some extent Germany, place emphasis on the development of a *climate* favorable to industrial development, and usually do not resort to more selective industrial policies in any systematic manner.

To illustrate the difference in these approaches, witness the recent action of the Japanese beginning to dismantle significant parts of their steel and shipbuilding industries in reaction to severe world overcapacity in these markets. Such an orderly contraction of export industries would be virtually impossible in the U.S. and most other countries lacking more systematic economic planning.

Export targeting.—Industrial policy also ties in with the export strategy of "targeting" exports to capture market share in specific industries. The developing nations quite sensibly target their exporting efforts in areas where they will have a comparative advantage. We have seen the situation in Asia where Taiwan, Hong Kong, and South Korea have supplanted Japan as exporters of textiles and footwear to the United States. In contrast, industrialized nations seem to be targeting their export development toward "big ticket" and high technology products, such as aircraft and computers.

The United States can look forward to increased competition in the export market in high technology areas. The Europeans are continuing to try to increase their share in the civil and military aviation markets, and the Japanese are reportedly targeting their export development efforts in the area of computers. I would like to point out to the Committee that aircraft and computers represent over 10 percent of our exports of manufactures, and over 20 percent of our exports of capital goods.

Industrial policy and export expansion are not, of course, synonymous. But for many nations, particularly the smaller ones, programs to develop new industries or to revitalize depressed regions must look to export sales to provide sufficient markets. Thus, separating export programs and incentives from regional and industrial development programs can be difficult if not impossible.

Research and development policy.—The Subcommittee has, I know, a particular interest in foreign country activities in the technology area. For the past three decades, the United States has carried out a dramatically large proportion of the total research and development (R&D) undertaken by the world. There are many ways to try to assess the quantity of resources going to R&D; many are somewhat conflicting, as this is by nature an imprecise concept to attempt to measure.

Nonetheless, in measures of both costs and in number of personnel involved, the U.S. share of total R&D has been large indeed. Perhaps the most accurate and comparable figures are for the United States and five other major industrial countries—Germany, Japan, France, Canada, and the United Kingdom. In 1976, it is estimated that U.S. R&D spending was still substantially greater than the *combined* total expenditure of these other countries.

Although U.S. R&D is large in absolute comparison, our advantage has in past years shown an unmistakable relative decline. It is impossible to be quantitatively precise—and I don't think any single measure is necessary to show that such a change has taken place. The simple fact is that many other industrial countries have increased their R&D expenditures until they are now devoting roughly the same proportion of GNP to research as we have. For example, ten years ago U.S. R&D spending amounted to nearly 3 percent of GNP; in 1976 the percent was 2¼ percent. In comparison, German R&D in the early 1960s was about 1.5 percent of German GNP; today their R&D percentage roughly matches ours.

It is fundamentally important that our R&D efforts continue and expand. The fact that other countries are also expanding their research efforts should not by itself give us cause for alarm. New discoveries, products, and capabilities abroad can make us all wealthier—sharing in these comparative advantages is, in fact, precisely the reason we engage in international trade.

What concerns me, however, is that we must continue the research effort—and expand it—whether others are expanding or contracting their research.

The improvement in our economic well-being depends heavily on new development and new technology, and it is to our advantage to expand efforts in this regard. My point in looking at foreing countries is that they have been very adept at following our example; the rapid expansion of R&D efforts overseas should be reinforcement for our renewed efforts.

Exemptions from General Policies.—The Subcommittee has expressed an interest in the degree to which foreign governments have made special exemptions in areas such as pollution and antitrust to promote exports. Our analysis of the situation indicates that while the issue of special exceptions has often been raised, there has been almost no evidence to substantiate the charges. The main impact on trade from environmental standards and antitrust laws seems to be due to differences in overall national policies, rather than from special exemptions to those policies.

In the area of pollution, since 1971 the United States and the other members of the Organization for Economic Cooperation and Development (OECD) have been actively studying the possible trade and investment effects of differing environmental standards among member countries. To date, none of the many studies conducted by the OECD in various industry sectors has shown any significant trade or investment effects resulting from differing environmental standards in member countries.

A recent study by Edward Denison for the Department of Commerce suggests, however, that the relatively vigorous environmental standards in this country are having an adverse effect on productivity levels. As I mentioned in my previous testimony, a development like this could have a negative impact on our export performance in the future. In the non-OECD countries, any environmental effects on trade that may raise tend to stem from the fact that these countries generally do not have environmental controls, and not from any special exemptions.

The same holds true in the antitrust area since the United States deploys the most stringent antitrust legislation in the trade area. In Japan, for example, the large trading companies which dominate Japan's international trade are encouraged by the government and face no antitrust problems even when they cooperate with each other. It is clear that U.S. companies of this size would face difficult antitrust questions if they behaved in a similar manner.

FINANCIAL INCENTIVES

The governments of the other major trading nations have responded to the trade awareness of their business communities by offering a wide array of financial incentives for exporting. The types of incentives that can be created seem to be limited only by human ingenuity. The U.S. program of incentives is generally less versatile, and in some areas is considered not as competitive, although it is very difficult to make comparisons on the relative effectiveness of different types of incentives.

Each of the major trading nations has been shaped by a different set of historical circumstances and events. The appropriate set of export incentives is not going to be identical for each country, and in most cases, it is impossible to say that a particular incentive is better than another. All we can generally say is that a particular incentive may be best for a certain country, or that certain countries are more aggressive in offering a variety of incentives.

I will not present here a full list of the types of financial incentives used in different nations. The operation of the export incentive programs of the more important trading nations has already been well documented. (An inventory of the export incentives used by the major trading nations was made by the U.S. Treasury in 1972. This inventory was subsequently updated by the Special Committee for U.S. Exports and appears in the testimony given last November to the Subcommittee on Trade of the House Ways and Means Committee. In addition, the Congressional Research Service is currently doing a series of studies of the export incentives and export promotion programs in the major trading nations.) Instead, I want to focus my attention on some of the more important and controversial financial incentives.

Tax incentives.—The anti-subsidy provision of the General Agreement on Tariffs and Trade (GATT) allows the remission of indirect taxes on exports—such as excise, turnover, and value added taxes. The provision prohibits the remission of direct taxes or income taxes. Many of our trading partners, particularly in the European Community, rely heavily on indirect taxes such as the value added tax (VAT) to secure revenues. Therefore, their border tax adjustments, which refund the VAT paid on exports, are not in violation of the anti-subsidy provision of the GATT.

The VAT, including the border taxes and rebates, does not directly provide an export incentive any more than not applying U.S. sales taxes to exports provides U.S. exporters with an incentive. It is possible, however, that the European preference for indirect taxes instead of direct taxes does shift more of the tax burden onto the domestic consumer and away from the foreign purchasers. On the other hand, most European nations have much higher overall levels of taxation than the United States.

Most of the other major trading nations use methods of taxing their exporters which gives these firms advantages unavailable to U.S. firms. For example, many nations tax income from foreign subsidiaries of their domestic firms at very low rates. Exporting firms in such countries can establish sales subsidiaries in low tax jurisdictions and avoid most of their home country tax burden on export sales. Under the U.S. tax structure no such tax saving mechanism is available. The worldwide income of U.S. companies is taxed at an identical rate, subject only to a credit for any foreign income taxes paid.

This tax saving mechanism for foreign firms can place U.S. exporters at a disadvantage in the profitability of export sales and in price competitiveness. The effect of this was documented in a submission last November by the Special Committee for U.S. Exports to the Subcommittee on Trade of the House Ways and Means Committee. Senator Heinz referred to this document during my testimony on February 23rd.

There has been some concern regarding Japan's use of tax incentives to expand exports. However, Japan has recently altered its system of tax incentives. Most of the past incentives have been suspended or modified. At present, the Japanese are emphasizing tax deferral and special deductions, especially for smaller and medium-sized exporters. For example, smaller Japanese exporters are permitted a five-year partial tax deferral as a "reserve" against losses in developing new overseas markets.

The developing nations continue to rely heavily on direct export subsidy programs as a means of stimulating exports, although they are becoming more sophisticated in their approach to export incentives. These direct subsidies usually take the form of pro-rated cash payments to firms for their export sales, credits against corporate income taxes, or special rebates of indirect taxes.

The major form of tax incentive which the United States has provided for our exporters has been the Domestic International Sales Corporation (DISC). The DISC provides for an indefinite deferral and not a remission on direct income taxes on exports. For a number of reasons, including questions about its effectiveness as an export incentive, the Administration has requested that the DISC program be phased out over a three year period.

Other incentives.—The most important form of non-tax export incentive is export financial. Every trading nation has some institution similar to our Export-Import Bank. Since President Moore of the Eximbank is testifying this morning, I will defer to him for testimony regarding export financial activities. I do wish to note, however, that business opinion has regarded the Eximbank as not fully competitive with its foreign counterparts. However, in the past year the Bank has become much more competitive, and I fully support President Carter's request for a significant expansion in the Bank's lending authority.

Beyond export financing, the United States offers little to our exporters in the form of supplemental official support. The other major trading nations have a wide variety of nontax export incentives available. The most important of these are mixed credits, local cost financing, and insurance coverage for inflation and exchange rate fluctuations. Of course, not all of our competitors offer all of these incentives, but France, Japan, and the United Kingdom have a very wide variety of supplemental non-tax incentives available.

These export incentives are a topic in the negotiations currently being carried out within OEC on revising the 1976 Consensus Understanding on Export Credit. The United States is attempting to get the other OECD nations to agree to a standardization of export credit practices and to fuller disclosure of specific credit transactions. It is in the interest of all countries to limit these kinds of export incentives rather than to engage in their escalation.

Multilateral trade negotiations.—The U.S. Government has become very concerned over the growing use of tax incentives and subsidies for exports in other nations. Under the GATT, most industrialized countries have agreed to prohibit the use of subsidies to foster exports of industrial products. This prohibition does not currently apply to developing countries or to exports of agricultural and other primary products.

Our position at the Multilateral Trade Negotiations is that the coverage of this prohibition on export subsidies should be expanded. Further, new controls need to be established over the use of domestic subsidies which have significant trade-distorting effects. This is particularly important because, as I noted earlier, regional and industrial development programs frequently result at least indirectly in subsidies to exports.

An interesting feature of many foreign export expansion programs is that special incentives are often made available to medium- and smaller-sized firms. Germany, Japan, Italy, and France all have export incentives aimed at the smaller potential exporter. These nations, particularly Japan and France, have expended considerable resources on promoting export awareness and providing assistance to small firms with export potential.

Before turning to export promotion programs, I would like to reiterate my belief that financial incentives for exports do have an effect in a floating exchange rate environment. It is sometimes argued that financial incentives will be cancelled out by changes in the exchange rate and, therefore, incentives are not really needed. The value of any currency reflects the total of all international financial flows in that currency—not just trade flows. The exchange rate does not move solely in response to changes in the value of exports. Exchange rate fluctuations, moreover, are frequently unpredictable by firms. Financial incentives, on the other hand, are seen as being a more enduring element and can have a favorable impact on companies' attitudes and on the level of exports. Incentives, for example, work to reduce the tendency of some U.S. firms to favor domestic orders over foreign orders.

EXPORT PROMOTION

Export promotion or marketing assistance programs are one area where it is possible to make international comparisons concerning the scope and emphasis of different national programs. By any of various financial measures, the United States does less in this area than most other trading nations. Also, the U.S. program has been unique in its emphasis on overseas trade centers. The main thrust of our program has been to stimulate foreign demand for U.S. exports through the trade centers, various trade fairs, and other forms of overseas trade promotion.

Since this Subcommittee plans to hold later hearings on the detailed operations of our export promotion program, I will restrict myself to an overview of the emphasis which different nations place on their marketing assistance programs.

Our major competitors give substantial promotional and marketing assistance support to their export sectors. By the more recent data (fiscal year 1976), the central governments of Japan, the United Kingdom, Italy, and France spend more money each year to promote manufactured exports than does the United States. The United States does spend more than Canada and, surprisingly, Germany. The range of spending runs from $13 million for Canada to $108 million for the United Kingdom. The United States allocated $23.5 million for its promotional expenditures on manufactured exports.

The comparison among countries, however, is more meaningful in relative terms, for the size of exports varies considerably from country to country. In relative terms, the United States spends only about $340 in export promotion for each million dollars of manufactured exports. Among the major trading nations, only Germany spends less—about $140. Canada, France, and Japan all spend around $600, while Italy spends $1,400 and the United Kingdom spends $2,500. In terms of the budget of the central government, the United States spends less than one hundredth of one percent of its budget on export promotion while the other major trading nations average about six times as much (six hundredths of one percent).

These figures are rough and certainly open to qualification. For example, the relatively small promotional efforts of the German government are supplemented by a large private sector program built around trade associations and overseas.

German Chambers of Commerce. While the private program receives some direct aid from the government, German law requires that exporters join and financially support these groups.

The export promotional figure of $23.5 million for the United States was the fiscal 1976 Department of Commerce budget appropriation for our promotional activities aimed at manufactured exports. In addition, the Department of Agriculture has a promotional program for agricultural exports, and the State Department has its commercial officers program.

Thus, it is possible to get a somewhat larger figure for the export promotion programs of the United States and Germany. Even so, export promotion—especially for manufactures—still receives significantly less emphasis from our government than ~~from~~ foreign governments.

However, the important point is not so much the amount of resources used for export promotion in different countries, but rather the effectiveness with which those promotional resources are used. One only has to note that the nations with the greatest apparent success in exporting are not necessarily the ones devoting the most resources on a relative basis to export promotion. It is my feeling that the greatest need in the U.S. export promtion program is not more resources, but a more effective use of the resources we already have.

I would like to make a few concluding points before turning to a discussion of our plans for the U.S. export promotion program. Our present record trade deficit is in many ways a short-term phenomenon. When economic recovery picks up overseas, our deficit will shrink. However, I am very concerned about our longer-run trade position. In my speeches and testimony I have stressed the importance of longer-term policy instruments such as energy conservation and export expansion.

The public is very concerned over the trade situation because of the enormous deficit. I do not want anyone to think that my suggestions are simply to meet a trade crisis, and when that crisis passes—and pass it will—that such things as trade expansion and energy conservation are no longer important. Export development, for which I have a direct responsibility, is vital to the long-run health of our economy.

THE NEW U.S. EXPORT DEVELOPMENT PROGRAM

I have spent many months studying our export promotion efforts, talking to members of the business community, and considering the recommendations of Congress. Based on all the information I have gathered, I have concluded that a major shift in the focus of our export promotion activities is needed. First of all, we should be putting much more emphasis on export stimulation at home. We need to foster a stronger export consciousness among our manufacturers; provide better and more specific export information; and provide more personalized service that will help firms overcome impediments, solve marketing problems, develop effective export strategies, steer them into the best markets for their products, and get them properly established in those markets.

Secondly, we need to be more successful in reaching and helping greater numbers of small and medium sized firms. Many such firms in the United States are capable of exporting, but are not doing so. Also, many others, while already exporting, are not selling as much abroad as they could. These smaller firms generally need more help in exporting than larger firms. They are less aware of the potential of exporting and less confident about their ability to do it. They are also less knowledgable about how to export and where to go for help. In addition, because their resources are limited, they cannot afford to pay as much for needed assistance as larger firms. We simply must do a more effective job of reaching these types of firms; and to do this we will have to offer them the kinds of services that are best suited to the needs and capabilities and which they would be most able and willing to use.

The third major area where I see a need for change is in the way we deliver our services to our target audience. We are just going to have to be more responsive in our assistance efforts. If a firm has an export problem or question, it should know where and to whom to come for help, and we, in turn, must get them good answers and solutions promptly. No firm needing our services should go away frustrated or with the feeling they were no better off than before.

One solution here, I believe, is to improve coordination and communications between the Department of Commerce in Washington and the District Offices and the overseas missions in the field. We must see to it that all three legs of the delivery system become full partners in our export development efforts. Each should know fully the thinking, programs and capabilities of the other. With Washington functioning as the nerve center, procedures can be streamlined and high-speed communications facilities utilized. There should be more interchange among staff and functions and continuing stress placed on the importance of providing personalized assistance to U.S. firms wherever they happen to be—overseas, in the grass roots of America, or in Washington. Our people in the field offices are in daily contact with your constituent companies. But they and the businesses with which they work need better support and we are going to provide it. The bottom line is that when a potential exporter calls the Department of Commerce, he should be able to get the help he needs fast and from any part of the organization that can help. He shouldn't have to root around like a hunting dog and then come up with an old bone.

With all these needs in mind, I have already begun to take steps to shift our export promotion emphasis and to make the improvements in our services which I feel are necessary. I plan to make more changes in the future. I am now considering a realignment of the Bureau of Export Development which will strengthen the focus on domestic stimulation activities along the lines outlined above. We are also considering a number of new program initiatives which will further strengthen and improve the quality of our promotion services, again with special emphasis on domestic export services. In addition, we are working with the State Department to assure that overseas missions given high priority to commercial services, and that the officers stationed abroad have solid backgrounds and abilities in this area and are attuned to the needs of U.S. industry, particularly smaller firms. We would be greatly aided in doing this if we are capable of developing an efficient and modern information exchange system.

Perhaps the best way of illustrating what we are trying to do is to conclude with some examples. A few years ago, an official of the Commerce Department went to interview a successful exporter in Minneapolis. This firm was a manufacturer of truck mirrors and had modest export sales to nations like Peru and Australia. It turned out that these foreign sales were to places where the firms's owner had vacationed. The Commerce Department was unable to help this firm to identify new export markets, because the information on where its truck mirrors might be needed was not available. We are changing this situation. We intend to be able to target individual firms to individual exporting opportunities. We are going to go out to these firms—we are not going to wait for these firms to come to us.

We intend to be able to help firms solve their problems in exporting. The U.S.-Japan Trade Facilitation Committee is a good example of what we are doing. Recently an American exporter of food products had difficulty with the Japanese tariff classification authorities. The U.S. exporter considered his product to be a prepared vegetable which would carry a 16 percent tariff. The Japanese authorities wished to classify the product as a confection with a 35 percent tariff. The exporter came to us with his problem and through the Trade Facilitation Committee the question was resolved in favor of the U.S. firm. This is the kind of assistance we intend to make available to all our exporters.

As I said at the beginning of this testimony, exports have been more important to the economic well-being of other nations than to the United States. We are not as dependent as other major trading nations on exporting to maintain our high standards of living. Our propensity to export is not as well developed. Nevertheless, we are a strong exporting nation; we have a wider range of product offerings; and our products can compete effectively in foreign markets.

We must not allow ourselves to sit back contentedly on our laurels as one of the largest exporting nations. Rather we must develop and enhance ways of increasing our exports. We still have far to much unutilized export potential in this country. I believe that this program I have just outlined will be an important step in developing our export potential, expanding our exports, and making the United States a still more competitive factor in world markets.

Senator STEVENSON. I agree with what you said at the outset about the need to change the environment of the United States. We have never really felt the need to spend or rely on exports because we have been able to prosper on our internal markets.

Could you—and I rcognize that the numbers can be misleading, but how many jobs in the United States would you say are directly dependent on exports or, to put it differently, what percentage of all jobs in the United States are dependent on exports? I have seen the figure one out of six. Is that way off?

Mr. WEIL. The more accepted number at the moment is something more like 1 out of 8 or 1 out of 10, but the more important fact, I think, is that in net terms the figure is probably a wash. In other words, imagine a situation in which the United States neither imported nor exported manufactured goods. The jobs that we would lose by not exporting would be, in theory, made up by the jobs that would be created by not importing.

The difficulty of course, is they would not be in the same areas, and we have less ability in this country to restructure our industrial capacity than other countries. Obviously, such a situation will not exist, but to speak in terms of a net plus of jobs for exports alone is probably a mistake because we have to look at it in the context of the jobs that are being lost, if you will, to things manufactured abroad and brought into this country.

However, it's true that probably about 10 million jobs in this country are directly related to things that are exported, and it's true that if we were exporting more there would be more jobs as a consequence.

Senator STEVENSON. Yesterday I began reading the latest version of the Humphrey-Hawkins bill which is now being considered by the House. Have you read that bill?

Mr. WEIL. I have to say I have not. I'm generally familiar with it.

Senator STEVENSON. Unfortunately, not many people including many who support it and comment on it, have read it. It's very instructive to read it. I haven't finished reading it. It's not the most exciting bedside reading and it would give any grade school grammar teacher nightmares.

So far, in my own reading of it, I haven't come to the first word about exports. How many jobs are related or not related to exports is hard to say and regardless of your net theory, increases in U.S. exports are bound to increase job opportunities in the United States and, yet, there is not I believe one word in the Humphrey-Hawkins bill about the importance of export policy to the United States.

It's got a little at least of something for everybody except exports, the export sector, export industries, export policy.

Why—I won't ask that question. I was going to say why haven't you read it. I agree with you about the environment. I mentioned this as an example. You talked also about coordination between agencies. Shouldn't the Commerce Department be addressing itself to that facet of Humphrey-Hawkins?

Mr. WEIL. The Commerce Department, if one can say it this way—the Commerce Department surely has read that bill. This part of the Commerce Department hasn't focused on it, but I assure you, in the light of this little discourse, will. I think your observation is instructive, but I think it also highlights a point that I made on February 23, and didn't want to repeat today, but maybe it bears repeating. That point is that we have not had an export mentality because we have not been an importing nation until the last several years. I think it's only a question of time before we as a Nation develop a broad consensus consciousness of the need to provide an environment in which exports are an important part of the economic process.

Exports comprise only about 6 percent of our GNP, as Senator Heinz said. Yet with most of our industrial trading partners it's more like 20 percent. It is clear to me that we need a national export policy, which is something that would encompass many things—one part of it being a consciousness of the effect of everything we do upon exports, positive or negative. It would also include a series of steps which would create a very positive environment to induce many more American firms to look beyond our borders. That appears to be the thrust of this consideration.

Senator STEVENSON. Well, that's what we are here for, to help develop, belatedly, that export policy.

You used an interesting expression. You said other nations target opportunity and we are observing this, though how it's done is not altogether clear. But I have the impression that the Japanese, for example, face up to worldwide overcapacity in such industries as steel and ship building and instead of reacting as we would normally and instinctively to subsidize industries producing commodities for which there is no market or an oversupply, they in government and industry cooperatively identify new targets. That is to say markets for which they then cooperatively develop the products, sometimes shifting out of one industry and into another, and typically out of the labor intensive industry into a high technology industry, with the result that the United States which once suffered from competition in labor intensive industries and still does is now suffering from more and more competition in high technology industries and, of course, continues to support by one device or another industries which are faced with an overcapacity in the world.

How, in our environment, our very different system, can we go about cooperatively targeting opportunity, which I assume might mean putting aside the adversarial relationship which typifies Government and industry in the United States to work cooperatively to identify markets and to develop products for those markets? Maybe it's a new generation of aircraft. In the United States it seems to happen accidentally. It's related to national defense. There's a spinoff which produces air frames that become pre-eminent in the world—with a slight caveat at the moment for the Airbus—or it's space technology which by accident spins off and produces digital watches or what have you.

How do you think we could go about targeting opportunity systematically, not by accident, and with a view toward not just producing weapons that are preeminent but industrial products that are strong in the world?

Mr. WEIL. Well, I think your touching on the national defense aspects is very wise because, I think to some extent there may have been a form of deliberate industrial policy in that. I think that there was probably a consciousness at the time some of those investments were made.

But outside of that area you touched on a very difficult subject, because I think it will require a substantial change in national attitude to accomplish very much.

Businessmen are very concerned about Government getting too involved in planning their world, yet I find businessmen are among the quickest to come crying to Government for help when they have a problem, and I find this paradox difficult to deal with now as a Government official, as I did in my earlier life as a businessman. I'm puzzled at times as to why businessmen feel they could take that inconsistent position. As long as that attitude persists I would judge it will be difficult, especially when you add on top of that the size and complexity of our economy compared to most of those countries which do have an industrial policy. There's a great risk, I think, that concerns our businessmen, which is that if we had a planning system—made it possible to devote Government funds other than in the research area to get out ahead of the problems—then they would lose their freedom. This a fundamental social-political problem. It is really not a business problem. Airing the issue as we have been doing today is one way to begin.

Senator STEVENSON. I'm not suggesting planning. I don't see why planning is necessary. Let me be more specific. The Government through its policies creates markets. It's in as good a position as the market is to anticipate markets sometimes. For example, the Congress in this session and the administration will both be considering deregulation of the aviation industry which is another example, incidentally, of the paradox of the kind you mentioned. Industry is always against regulation until it's my regulation. The airline industry for the most part is very reluctant to give up its regulation, but I think it's coming. The Commerce Committee of the Senate has already reported such legislation.

If it comes, it could shape the aviation industry. It could produce a very different system. That system might evolve even without the deregulation. It might mean more large hub airports to serve each other and regional airports then, which would mean a much larger market for commuter aviation. There hasn't been a major product improvement—that's perhaps a little unfair—there certainly hasn't been a major technological innovation in the general aviation or commuter aviation field for many, many years. There may be a market out there for it right now.

Why can't we, with our resources such as NASA, help to develop products for that market? That doesn't require planning, does it?

Mr. WEIL. Well, it's a form of planning. The word is an unhappy one because it has connotations that make you a little nervous. But when it means applying resources to a perceived future problem, that in my view is Government planning. The Japanese foresaw the fact that they would have to give ground to the textile industry a number of years ago. They then planned to move into automobiles and television sets and now are planning to move into computers. That is what I mean by industrial policy.

Senator STEVENSON. Let me interrupt at that point, Mr. Weil. I have been up here longer than you have, so please don't use that word. You're creating unnecessary problems for yourself. If you will just talk about targeting opportunity, which is the first expression you mentioned, and helping business, you will get a lot farther with business than by using that word planning, and I don't think it's really necessary. We are getting into a semantic problem here which creates unnecessary political problems for us.

Why can't we join with business to help target those opportunities? Maybe it's in aviation, maybe it's in the computer field, maybe it's in optical fibers, maybe it's something else—instead of what you're targeting. You have in the Commerce Department the cooperative technology—What's Jordan——

Mr. WEIL. Publicize technology——

Senator STEVENSON. But he has a special program. What does it target? It targets jewelry. Why are we targeting jewelry instead of optical fibers?

Mr. WEIL. I'm sorry. I can't answer that question.

Senator STEVENSON. Well, you're already trying to do it. You have an experimental program in Commerce on the research and development side.

Mr. WEIL. I'm generally familiar with it.

Senator STEVENSON. We're targeting three industries, one of which is jewelry I'm told; another of which is shoes, which according to GAO really isn't suffering from foreign competition; that's not its problem. Maybe we ought to be targeting shoes. I don't know. It wouldn't offhand strike me as an industry with larger potentials for exports throughout the world. And the third is the one that the Japanese have seen the handwriting on the wall and are moving out of that you just mentioned, the textile industry. Granted, it needs help with which to serve just domestic markets. Others when they target opportunity will begin to move industry and people out of such an industry faced with overcapacity throughout the world into the production of new commodities for which the markets are just emerging.

Why can't we do that? We are already. If that's planning, then the Commerce Department is already planning.

Mr. WEIL. Well, I think that's right, but without deflecting from your point, I think that we have targeted certain areas, one of them being the construction of nuclear power facilities around the world. This, in fact, is a good example of some of the problems that we have as an exporting nation. We have for a variety of reasons, serving a variety of social purposes—many of which we all approve—imposed restraints. We are harming the U.S. business sector in many ways and making it difficult for them to sell their products around the world. There is a very large market for which there is very large need. We have a very well established capability, but we are currently losing our market share because of self-imposed restraints.

Senator STEVENSON. Well, let's get into some of those restraints then. The Japanese also have trading companies. I think one of the problems from where I sit at the moment is that many businesses are intimidated by the mysteries that they perceive when it comes to exporting. I used to be a lawyer representing small businesses. They are just overwhelmed by the thought of trying to market their commodities in Japan or Kenya or wherever it is. The Japanese set up trading companies which very effectively, very aggressively market Japanese products of all kinds produced by all kinds of Japanese businesses in all places in the world. We can't apparently create such trading companies, a few giant trading companies to market American products throughout the world, because to do so would probably violate the antitrust laws.

Mr. WEIL. Well, that isn't altogether clear. I think that we have export management companies and certain kinds of trading firms. I think there's a more historical reason why the Japanese have this handful of giant trading firms. I think it has a lot to do with the fact that the Japanese were dependent upon exports because of their island economy. They concentrated a lot of their abilities and energies on these companies because they had an island society. Those companies got started in the early part of this century when Japan sought to go out in the world, and, like a lot of enterprises that began in the early part of this century, they have become very large; so, I think there is that historical reason.

As I indicated earlier, during that whole period of time we were not concerned with the same problems.

Senator STEVENSON. Well, that's history, but if history has any relevance, it's because we have something to learn from it. Are you suggesting that there's nothing to learn from this Japanese experience?

Mr. WEIL. I think there's a lot to learn from it.

Senator STEVENSON. What?

Mr. WEIL. There are some large companies in this country that have great abilities around the world. Some of those companies are looking for new opportunities. Take an example IBM Corp., which has been——

Senator STEVENSON. IBM can market very effectively around the world and so can Caterpillar. What about the little guy? He needs a worldwide trading company to represent him, to sell his products, doesn't he?

Mr. WEIL. Well, I guess what I was aiming at, in response to your question, is that—and I don't know the answer to this—if IBM decided to set up the IBM trading company to utilize some of this excess capital and utilize its abilities to sell around the world, whether or not that would be in violation, it might in turn buy from American manufacturers a lot of products totally unrelated to what IBM is doing now.

Senator STEVENSON. Shouldn't the Commerce Department be looking into that possibility? Maybe we should change the antitrust laws.

Mr. WEIL. We are looking into it.

Senator STEVENSON. Are you going to have some suggestions for trading companies?

Mr. WEIL. We may. It's too premature to comment, but we have got some work going on in this area.

Senator STEVENSON. Don't hesitate to suggest changes in the antitrust laws if it's necessary to permit us to compete on an equal basis with our competitors, and if that's what's necessary I offhand don't know why Congress wouldn't be happy to go along.

Mr. WEIL. It may be, but one of the things we need to do is utilize a number of these large companies—I don't want to single out IBM—that have great capacity and great abilities throughout the world and try to get more of our industrial products out through them, as distinct from trying to get the smaller firms who are intimidated by this process to do it on their own. That is something we are exploring.

Senator STEVENSON. While we're on the subject of self-inflicted wounds, some would say that the United States is depriving itself of access to significant markets in Eastern Europe and the Soviet Union and some would say also that in addition to depriving itself of market opportunities in these countries it's also depriving itself of the political leverage of sales, including Exim credits, CCC credits, to make them available in those countries and that it is possible for the United States with a little ingenuity and some courage to take advantage of the economic opportunities and the political opportunities in these countries with a formula for credits and MFN that makes more sense than the present formula. Would you respond to that proposition.

Mr. WEIL. I have already spoken a little bit about this on February 23. We share that general view——

Senator STEVENSON. "We," meaning the Carter administration?

Mr. WEIL. We, the Department of Commerce; we being me. As we discussed a couple weeks ago, that's a very complex, delicate series of issues; but there's another underlying problem, leaving aside all the other political issues which we also discussed, which is that to be effective the trading has to be two-way. Our analysis tells us at the present time that there's not a great deal that those countries have that we need in great quantity. In the longer run we have to build our trade relationship with those countries——

Senator STEVENSON. Well, the trade balances of those countries are very favorable. You're not complaining about that?

Mr. WEIL. That's the point. They are so favorable that it's hard to expand them, because unless we extend them substantial credits, their ability to buy more from us except what is absolutely essential——

Senator STEVENSON. That's what I was asking you. I was asking about credits and MFN. In some of those countries at least—I just returned from some of them—they are mighty eager to get credits. Of course, we do make credits available in a few of them for reasons that are not altogether clear—some we do and some we don't—some of the more repressive countries we do, and some of the least repressive we don't, and it's a little difficult to understand this policy except in the context of American politics which doesn't always produce rational results—but clearly, with credits, there are export opportunities in this country that are not being taken advantage of now. The Soviet Union is an unusual case because it can get credit, and the last I heard, at about three-quarters of a percent over the London Inter-Bank rate. It can get credit now on terms that are comparable to those made available by the Eximbank. It doesn't really need credit for the sake of credit, but it wants credit for other reasons, and with it there would be more export opportunities in the Soviet Union and the trade balance in favor of the United States would become even more favorable, wouldn't it?

Mr. WEIL. There's lots of potential there. There's no question about that. The Soviet Union, as well as Mainland China and other parts of Eastern Europe, have great need for lots of our technology and capital goods. If we could ever find our way generally to relieve some of the problems that are unrelated to trade, there's no question that the export opportunities for the United States in those markets would be substantial.

Senator STEVENSON. And as I indicated before, there are those that say that in effect by making credits unavailable we deprive ourselves of all the political leverage, whether it's been with respect to immigration or SALT or the Horn of Africa or the Middle East, but that's not your field.

Mr. WEIL. Well, I have to say that I would differ somewhat from what I sense to be your judgment there.

Senator STEVENSON. From my judgment? You're the witness. I haven't expressed a judgment.

Mr. WEIL. Well, there's an implied judgment that if we did a lot more business that the potential would be there to have more influence on their activities in other areas. I don't know enough about this.

Senator STEVENSON. I didn't want to leave you with that impression. I'm pretty hard-nosed on this. The suggestion I was trying to make was that credits conditioned on continuing review and evaluation of behavior against—many issues, not just emigration—and the possibility of discontinued credits—is a more discreet and therefore a more effective way of using leverage than are some of the more explicit means which have been suggested and are law. That's the proposition—without expressing a judgment about it—and I really don't expect you to testify here on these political questions. That's not your responsibility, but you have indicated I believe that this formula is depriving the United States of export opportunities.

Mr. WEIL. There's no question about that at all.

Senator STEVENSON. Would you say they are substantial export opportunities? Have you any way of quantifying that? Have you figures quantifying how much has been lost?

Mr. WEIL. It's hazardous to quantify, but it could be substantial. In a completely neutral environment, the trade potential with these areas—China, the U.S.S.R., and the rest of Eastern Europe—could be many billions of dollars, but that completely neutral environment doesn't exist, so the question is a bit abstract.

Senator STEVENSON. You discussed in your prepared statement tax incentives employed by foreign countries to support exports and noted somewhat cryptically that the administration had recommended a phase-out of DISC. Do you agree with that policy, that decision of the administration?

Mr. WEIL. I gave a number of speeches during 1977 in which I stressed the view that the DISC, while it was difficult to quantify how much it had contributed to the present level of export sales from the United States, was without any question a plus in terms of the export environment. It was my view then that the removal of DISC could be perceive din no other way than as a minus.

Having so spoken publicly, I cannot say that my mind has been changed. On the other hand, as I think I testified on the 23d, I don't see the whole picture and my job is to look at the export environment pretty much by itself. The President judged otherwise and I can't say that he's altogether wrong because the evidence is not overwhelmingly clear.

I do know that there are many large companies in this country that would tend to prefer their domestic orders to their foreign orders because their domestic business is a larger part of their business than most of their foreign competitors, and is thus more important. I also know that many large businesses have argued that one of the reasons why DISC was important to them was that it gave them an argument internally as to whether or not they should first ship their foreign orders or their domestic orders.

As far as small businesses are concerned, it is not widely recognized that small businesses have a lot of emphasis on DISC. They do it for a different reason, because they are more in need of a specific monetary incentive. It may be that there should be some distinction drawn between large companies and small companies in thinking of DISC, but the administration's tax bill has a phase-out over 3 years, and I guess as long as I'm going to be a member of this administration I've got to support the administration position.

Senator STEVENSON. One question more. We must move on. Are we losing export sales as a result of the antiboycott—anti-Arab boycott policy?

Mr. WEIL. It's too early to judge. I think again, as I said at the outset of my oral remarks today, exporting takes place in an environment which contains an amalgam of factors. As important as the boycott and the antiboycott regulations or law that we have are, the fact is that our major competitors in the Middle East are Japanese and Germans and the Western Europeans who are terribly dependent upon exports, which pay for their import of oil and other things, are competing very strongly out there. So when we lose business, which we do all the time, I think sometimes American businessmen point their fingers at something which is beyond their control and say that was the cause. Therefore, it would be easy to blame it on the antiboycott law and regulations.

That it has some bearing on trade in the Middle East is almost without question. We don't have any numbers, and I don't know whether we will ever have any numbers. My feeling is that for the large firms that are there and the way the regulations were constructed, it should be possible to be a good, effective competitor. The readings we have from the Middle East and from the business community in this country indicate that it should not be a substantial disability, particularly to the large companies.

Senator STEVENSON. It must vary from country to country.

Mr. WEIL. Indeed it does. Saudi Arabia, for example, is I think going to be one of our largest markets. There is less difficulty in Saudi Arabia than in Syria, for example.

Senator STEVENSON. Or Libya or Iraq.

Mr. WEIL. Yes.

Senator STEVENSON. Will you be monitoring that situation to try to quantify the consequences of that policy?

Mr. WEIL. We will be monitoring it. How much we can quantify it I'm not sure, because it's very difficult to sort out, as I said, why we lose a piece of business. What we will monitor is the levels of our exports in those countries as compared to our competitors, and then we will have to make an analysis of those changes. However, reasonable men will still differ on the conclusions they draw as to why we have perhaps not done as well.

One of the thrusts of this whole series of hearings is the export environment in general, and there's no question that the antiboycott law is a part of that environment, but it is at the same time a part for which the will of this country was clearly expressed by overwhelming votes; therefore we have to live with in and work around it.

Senator STEVENSON. Live with it and do what?

Mr. WEIL. To the extent that we need to keep that program—I don't mean to say that we will violate the law—we will work around the problem as you work around all kinds of problems. We will administer the law with accuracy and with the will that the law demands.

Senator STEVENSON. Thank you, Mr. Weil. I hope we can stay in touch on this subject. We want to be helpful and I think it's obvious that some changes are in order. What they all are I think neither of us really knows at the moment.

Mr. WEIL. Mr. Chairman, I thank you, sir. I think that the bottom line of our view could be summed up really in three words: we have need for a national export policy.

Senator STEVENSON. I wanted to ask you one final question. It's been suggested—many, if not all, countries do have ministries of trade. This administration likes nothing better than organizing and reorganizing the Federal Government. I wonder at times if we are ever going to get around to governing. How do you feel about a Department of Trade?

Mr. WEIL. Well, there is, as you know, a bill introduced by Senators Roth and Ribicoff, which proposes bringing together portions of the Department of Commerce, State, Treasury, STR. I have not studied the bill carefully, nor have I discussed it with other members of this administration. I think that there are obviously many pluses and minuses politically to considering such a thing. I think that the fact that some nations that are highly dependent on exporting have had such ministries or departments for a long time again points to the difference between their history and ours. It may be that the changes have occurred in our economic posture in the world over the last 5 years are such that we should consider such a department in order to improve our ability to function in the international economy. But that's more in the nature of a question than it is a judgment.

Senator STEVENSON. Thank you.

Our next witness is John L. Moore, the chairman of the Eximbank. We welcome you, Mr. Moore. You are familiar with the subcommittee. We are glad to have you back. I will invite you, as I will all our witnesses, to summarize if that's possible to save time.

STATEMENT OF JOHN L. MOORE, JR., PRESIDENT AND CHAIRMAN, EXPORT-IMPORT BANK OF THE UNITED STATES

Mr. MOORE. Yes, Mr. Chairman. We have submitted a rather lengthy statement for the record and I have a summary to give you.

[Complete statement follows:]

Statement of
John L. Moore, Jr.
President and Chairman
Export-Import Bank of the United States
Before the
Subcommittee on International Finance
Committee on Banking, Housing and Urban Affairs
United States Senate

March 9, 1978

Mr. Chairman, Members of the Subcommittee:

Thank you for the invitation to discuss the policies and programs which foreign governments offer to support their exports. The Export-Import Bank is continuously competing with the attractive financing offers of our counterparts in Europe and Japan. This competition has become increasingly important in a world in which similar technology and services are dispersed among numerous nations whose export sales are often crucial to the continued viability of domestic industries.

As you know, our statutory mandate directs us to aid in financing U.S. exports on terms which are competitive with the government-supported rates and terms offered by our competitors. Because of the unsubsidized nature of Eximbank's operations and various factors we have to take into consideration under our statute, we are not always able to be fully competitive with the financial support offered by other nations.

With this in mind, let me first compare the credit programs of Eximbank and its major foreign competitors, with particular attention to the ancillary schemes and incentives available from those competitors. I would then like to tell you how we have tried to offset these exceptional programs and how successful we have been.

Export sales historically have been of greater economic importance to our major trading competitors in Europe and Japan. Exports constitute between 15 and 30 percent of the Gross National Product in these countries, while in the United States overseas sales have typically accounted for only 6 to 8 percent of GNP. Because of this importance of export sales to national income and employment, foreign governments traditionally have placed greater emphasis on encouraging exports through official financing programs similar to those offered through Eximbank, though often more comprehensive.

This emphasis is illustrated by comparing operating data of the major government export financing agencies. In 1976, for example, our counterparts in Japan and France provided support for their exports which was, respectively, nearly five times and three times the dollar volume of Eximbank authorizations made during the same period. The support authorized by Eximbank's counterparts in Germany and the United Kingdom was each one-and-a-half times that of Eximbank.

Long-Term Competitiveness

Not only have our major competitors supported more exports, but their long-term credit programs (that is, five years and over) generally provide more attractive terms and conditions. Let me illustrate the relative attractiveness of foreign programs in relation to those offered by Eximbank by comparing the three major components of long-term financing: repayment term, percentage of contract covered, and interest rate.

Term: Despite differing philosophical approaches to setting appropriate repayment terms, there is little difference in practice in the length of time allowed under the various systems for repayment of the credit. The similarity of term reflects both the existence of various international agreements which specify maximum repayment term standards and the general belief that a small difference in repayment term is not an effective competitive tool. Accordingly, Eximbank offers repayment terms which are competitive with those offered by foreign agencies.

Cover: The percentage of contract value officially supported through direct government loans extended by the various official credit agencies tends to reflect the relative capabilities of the domestic financial markets and the relative importance of the private sector to the particular economy. After receiving a standard 15 percent down payment, exporters in France, Italy and the United Kingdom can anticipate that their respective official export credit agencies will cover the remaining 85 percent of the contract value. In Japan, the support typically ranges between 50 and 85 percent of contract value. However, private Japanese financing--when provided--is also on terms and conditions comparable to official financing.

Because of the strength of the private financial market in Germany, exporters often are able to obtain long-term, fixed-rate financing from private sources at low rates without official loans. In these cases, the private lender can obtain government insurance to minimize many of its risks. When private funds are unavailable, the official German agencies will lend between 40 and 85 percent of the contract value at fixed rates. The Canadian export credit agency will also finance, on average, about 60 percent of the contract value.

In addition, our foreign competitors often increase the effective amount of cover by providing direct loans or insurance for so-called "local costs" of the exported goods or services. Local costs are those portions of a project or service sourced in the buyer country. Local cost support historically has been for construction or infrastructure components but increasingly is applied to domestically-produced products of a more sophisticated nature. Although somewhat limited by international agreement, this form of support is very attractive, especially to government buyers, because it facilitates the involvement of their own domestic industry as well as decreasing equity capital needs. Eximbank recently reinstituted its previous practice of selectively extending guarantees for private local cost financing but only to meet known offers of local cost financing from our competitors and not exceeding 15 percent of the contract value.

In contrast, Eximbank direct loans usually finance between 40 to 50 percent of the contract value, with exceptional cases receiving as much as 85 percent. Therefore, reflecting our capital market and Eximbank's strong commitment to the private sector, Eximbank's standard percentage of direct loan participation is usually below that of our major competitors.

Interest Rate: The principal component of the effective cost of an official export credit is the interest rate charged by the export credit agency. As with repayment terms, the philosophical basis for determining interest rates differs between Eximbank and many of its foreign competitors. Because Eximbank indirectly borrows all its new funds from private capital markets, Eximbank's interest rates must vary from time to time to keep our lending rate above our borrowing rate. Thus, Eximbank's interest rates can be characterized as closely related to private market rates. Many foreign export credit agencies, however, receive annual subsidies which allow them to set their rates at whatever level is viewed as desirable. Accordingly, foreign rates tend to change only in response to political pressures, including decreases in rates elsewhere, or to conform to internationally-established minimum standards. They are, therefore, not "market related."

This difference in interest rates is aggravated by the fact that in a transaction including both Eximbank and private credit, the portion provided by a U.S. commercial lender is nearly always at a floating rate and typically higher than the rate Eximbank charges on its portion. The combination of these two rates--the so-called "blended" rate--is, therefore, usually both higher than that charged by foreign agencies and variable rather than fixed. Accordingly, the U.S. is generally regarded by U.S. exporters and some borrowers as uncompetitive in the area of interest rate.

In fairness, however, it should be pointed out that it is not always easy to equate interest rates in a world of floating exchange rates. A borrower has to consider not only the face interest rate at the time of entering into the loan, but also the probable cost of the currency at the time of repayment. For example, if the borrower expects the German mark to continue to appreciate in value compared to the dollar, the borrower may be willing to accept a higher dollar interest rate. The problem is that, while short-term projections may be made, most borrowers are unable to make long range predictions. As a result any advantage which the dollar may have in today's exchange markets will often be discounted somewhat by Eximbank borrowers.

Extraordinary Assistance

In addition to the normal export credit programs, many foreign agencies offer ancillary export promotion programs which are unavailable in this country. Most notable are the so-called "mixed credits" in which low interest rate development aid funds are combined with officially-supported export credits. France and, to a lesser extent, Japan operate schemes in which anywhere from 15 to 50 percent of the credit is extended on soft terms of 15 to 30 years with very low interest rates--typically 3 to 6 percent. Canada, Germany and the United Kingdom infrequently make such offers but on a less concessionary basis. Although our own U.S. AID programs are also normally "tied" to the purchase of products from this country, the U.S. does not soften the credit terms of a commercially viable product or project with AID funds in order to promote the sale of exports. "Mixed credit" financial offers effectively eliminate any competing offers which have to incorporate more commercial terms and conditions.

Of course, the use of soft "aid" funds to support exports essentially constitutes a subsidy to the exporter by the taxpayers of the country providing the mixed credit. That economic fact offers little consolation to the U.S. exporter who must compete with such non-commercial offers, however.

Other schemes offered by other export credit institutions include inflation indemnity and exchange rate fluctuation insurance. Inflation insurance--again used primarily by the French--protects exporters from exceptional cost increases occurring during the construction period, enabling them to quote either a fixed price or one with a modest price escalation exposure. The U.S. exporter must cushion against similar cost inflation by building a higher margin into his price. This feature can be very attractive to a buyer and is a deeply entrenched feature of the French system. Although the French argue that the inflation insurance program is self-funding through insurance premiums, it is our understanding that the program has actually operated at substantial deficits.

Exchange rate insurance protects exporters against losses from exchange rate fluctuations, generally above a certain minimum threshold, and can also contribute to a lower foreign quote. It is used primarily by exporters who are being repaid in currencies which may depreciate in value against the currencies which the exporter normally uses to pay for his own goods and services.

Most foreign export credit agencies will also cover the foreign content of their export provided that most of the export 's value is produced domestically. The European Economic Community member countries will officially finance exports with up to 40 percent of their value produced in other Common Market countries or up to 30 percent from non-Common Market countries. In Japan, up to 50 percent of the product value may be of foreign origin and still be eligible for official credit support. In practice, the degree of foreign content supported is usually much less, but the leniency of most other official agencies contrasts sharply with Eximbank's general policy of precluding foreign content from direct loans and private loan guarantee transactions.

Another strong competitive tool used by the Europeans and the Japanese is the extension of large credit lines with long availability periods. These lines are especially significant in the trade of our competitors with Eastern Europe and the Soviet Union. Such lines may constitute an incentive to place orders with those countries extending the lines. Eximbank has begun to utilize credit lines, but under our regular financing terms and only in highly selective circumstances involving short commitment periods and substantial administrative and security advantages for Eximbank.

Finally, the Common Market countries have been trying to institute a European export credit bank to provide services similar to those of the individual agencies but on a larger scale for Market consortiums. This idea, however, has met with considerable opposition from some members who are reluctant to subjugate national control of their export financing practices. The concept now appears to be a dormant issue.

<u>Non-Financing Aspects</u>

Foreign government support for export sales is not limited to financing alone. Let me discuss a specific European project which has precipitated extensive French and German government support, the A300 Airbus.

The wide-bodied Airbus is now competing effectively in the world market against U.S. commercial jet aircraft. Although Eximbank can usually provide aircraft financing substantially competitive with our French and German counterparts, there are features of the Airbus program with which we cannot compete. Most notable would be the production subsidies that enable Airbus Industrie to offer artificially low prices. It has been estimated that the sales price of every A300 is reduced 20 percent by government production subsidies. In addition, A300 sales offers often appear to be accompanied by special inducements. South African Airways, for example, purchased the aircraft at a special discounted price subject to the purchase of additional military equipment. A purchase by Indian Airlines was apparently influenced by prospects of negotiating a special trade agreement. A sale of Pakistan International Airways was reportedly linked to a French offer to sell Pakistan a nuclear reprocessing plant which the United States had refused to provide.

It should also be pointed out that most foreign export financing agencies have a more simple mandate than does Eximbank. They are not required to take into account the serious adverse effect of their financing on the remainder of their industries. Human rights considerations are seldom weighed. Specific transactions do not require prior approval by their national legislative bodies. There is no restriction on trading with most Communist countries, and so on. This is not to say that these restrictions on Eximbank activity are inappropriate. That is for Congress to decide. The only point is that the exporters of most other major trading nations can be reasonably confident of the availability of prompt financial support for their transactions.

This assessment is not ours alone. In the most recent survey of U.S. banks and exporters required for our semiannual "Report to the U.S. Congress on Export Credit Competition and the Export-Import Bank of the United States," the U.S. exporting community noted these same competitive advantages available to their foreign competitors. In addition, they sensed a greater willingness on the part of foreign governments to promote exports. These exporters also objected to the many external restrictions and constraints imposed upon the Bank. The need to determine adverse impact on the U.S. economy, the prohibition of activity in certain countries and the requirement of Congressional review of large authorizations were all singled out by survey participants as time-consuming and overly-restrictive practices that hampered the United States in competing in export markets.

Eximbank Actions

Eximbank has recognized that its programs are relatively uncompetitive and has recently -- to the extent possible within its present financing structure and legislative mandates -- taken steps to offset the competitive edge provided by foreign export credit agencies.

As directed by its statute, Eximbank has sought international agreements to reduce subsidized export financing. Eximbank has for many years actively participated in two international organizations which seek to reduce counterproductive competition in export credits: the Berne Union and the Export Credits Group of the OECD. A number of procedures and sector agreements have been established under the aegis of these two organizations which have set certain standards and limits on export financing practices. Furthermore, we make extensive use of two exchange of information systems operated by the Berne Union and OECD. Under these systems, Eximbank shares with its counterparts information on specific transactions of mutual interest to insure an accurate assessment of competing financing offers.

The Bank has also been a major element in the efforts of the United States to broaden the existing Consensus on export credit terms. These efforts have proven to be beneficial, although the negotiating process is slow and difficult, reflecting the historical and structural differences among the various national export financing system, export product mixes and trade patterns.

New International Export Credit Arrangement

On February 22, the representatives of 20 exporting countries reached tentative agreement on the text of a new International Arrangement on Officially Supported Export Credits. The Arrangement is scheduled to become effective on April 1, 1978. The Arrangement continues most of the substantive proposals of the present Consensus, although the United States pressed unsuccessfully for selective increases in minimum interest rates and restrictions on the use of ancillary insurance schemes and mixed credits. Bilateral and multilateral meetings over the course of nine months demonstrated the strong reluctance of most countries -- and particularly the European Community -- to make such substantive improvements.

Nevertheless, the Arrangement establishes for the first time needed definitions and detailed provisions for notifying and matching of non-conforming commitments issued before the Consensus or as derogations from the new Arrangement. After substantial deliberations within the

27-039 O - 78 - 3

Executive Branch of the U.S. Government, it was concluded that limited improvements were preferable to abandoning the Consensus. It was felt that abandonment would permit some participants to pursue export credit practices even less commercially sound than those permitted by the limited restraints of the new Arrangement.

I should emphasize that we gave only as much as we got in the new Arrangement, pointedly retracting some concessions we were prepared to make when it became apparent that many of the substantive improvements we sought were not forthcoming.

In the future, new competitors of Eximbank will be emerging. Many of the developing countries are seeking export markets to support their fledgling industries. Korea, Brazil and Taiwan are examples of strong developing countries that now have or are soon to set up export financing programs. Because their high-technology industries are likely to remain modest in size for the next few years, most of the export support in these countries will be for commodities, agricultural products and other non-capital products. They will, however, eventually emerge as competitors to the developed countries in the capital goods exports markets. We have had discussions with representatives of these developing countries and will continue to follow closely their official export credit activities as their agencies develop and mature.

Future Competitiveness

In the interim, Eximbank has demonstrated flexibility in trying to offset competitive foreign offers on a case-by-case basis. We believe that we can do more than we have in the past to be competitive — even within the constraints of the Consensus.

Using our general knowledge of foreign systems along with information obtained on specific transactions, Eximbank has taken a number of steps to modify our normal practices in the face of proven competition. Specifically, we have occasionally lowered our interest rate below our normal schedule and increased our direct credit participation to 85 percent. We have sometimes extended terms below our normal practice, although still within international consensus standards. In an attempt to reduce the extraordinary competitive advantage of long-term, low interest rate, mixed credits, we have, in one instance, offered a 100 percent credit with a 15-year repayment term and 7.5 percent rate of interest. We recently have also offered lines of credit of limited duration and use for specific projects. In three instances we have offered guarantees of private loans for local costs to try to offset foreign direct loans for local costs.

It is impossible to determine precisely how successful our attempt to improve the competitiveness of our support has been, since numerous non-financing features such as price, quality, availability, compatability with existing plant and equipment, and aftersales support also effect the success of an export bid. Eximbank does not attempt to offset any competitive disadvantage which our U.S. exporters may experience in those non-financing areas. Our mandate is simply to do our best to insure that an otherwise competitive U.S. exporter will not lose a contract because of the unavailability of reasonably competitive financing. Eximbank is now conducting a study of the relative importance of the financing factor in foreign buyer decisions to purchase from particular exporting countries.

Eximbank will continue to attempt to reduce the competitive advantages available to foreign exporters using subsidized financing systems. However, we cannot be expected to overcome many of the foreign financing offers. Although the Bank is now in a strong financial condition and capable of vigorously expanding its operations, the Bank's market-oriented financial structure and Congressional mandates do not always permit it to extend financing which is entirely competitive.

It is important, however, that we maintain Eximbank's financing flexibility so that U.S. exporters have a reasonable chance to compete primarily on the basis of price, quality and product technology. Aside from this issue of basic fairness, today's massive U.S. trade deficit demands that, for the foreseeable future, Eximbank must do all that it can to insure that U.S. exporters are competitive.

Senator STEVENSON. Thank you, sir.

Do you feel that Exim terms are comparable now to those of your counterparts except what—the French and the Japanese?

Mr. MOORE. Well, I think we are competitive with all of them and I will comment on that in detail, but we are competitive with all of them when you're speaking of export credits. We are not ever competitive if they are mixing aid credits.

Senator STEVENSON. Let's keep it right on the terms available from Exim and your counterparts, and then we'll get into the other support.

Mr. MOORE. As indicated in the prepared statement, the consensus appears to have worked fairly well in terms of the repayment terms. Most of the Nations adhere to the maximum term stated, so in effect we all are offering the same repayment terms.

Senator STEVENSON. Do you think the gentlemen's agreement is holding as far as it goes?

Mr. MOORE. Right. If anybody breaks that, everybody else immediately matches it, so there's not much inducement to break the arrangement on the repayment terms.

As to interest rates, because of the higher domestic borrowing rates now as compared to a year ago, we have a tough time being directly competitive because several of the others, specifically France and Japan, offer the minimum consensus rate fixed for the full amount of the loan and those rates in the lesser developed countries are 7½ percent. They go up to 8 percent in the developed countries, but, as you know, there's a not much needed from any of the official agencies for the developed country markets. So we are looking most of the time at 7½ percent fixed.

In order to produce for the Bank we need a rate for us that's at least 8 percent, so that meeting 7½ is difficult. The domestic lenders at present are charging around 9 percent floating at a minimum for the best credits so if you blend in their financing our package may well get to be at least 8½ to 9 percent.

The way to address that in a closely bid situation is for us to extend our coverage to 85 percent of the contract price and offer that rate which we think the foreigners might consider close enough to the 7½-percent to be competitive. We don't usually go as low as 7½, and I don't think we have to. I think we can go to 8 percent on the closer situations in most cases.

Now the final thing is the amount of cover, and there we are not very competitive because, as I indicated in my prepared statement, the other lenders will cover the downpayment, and they will cover up to 15, even 30, percent of local costs of their export value in local cost financing. When Eximbank has offered local cost financing it's always been limited to 15 percent downpayment and has also been limited to guarantee rather than a direct loan. So the borrowing rate is higher than that offered abroad. But on top of that, the foreign agencies will cover foreign content and we do not.

Senator STEVENSON. I should know but I don't know the answer to this. Are you prevented by law or is it Exim policy from covering foreign content?

Mr. MOORE. It's certainly policy. My General Counsel indicates that there's long legislative history supporting the idea that the direction to facilitate exports means just that, so that it's hard for us to do much on foreign content. I'm sure that to a limited extent we would be authorized to do so, but in allocating resources where ours are pretty strictly limited I really can't give that coverage high priority. If we were told that the sky is the limit—go at it to compete—obviously we would match those terms too. But in terms of allocating resources, I think that has a lower priority than bidding on more kinds of cases.

Senator STEVENSON. Well, let me just suggest that you consider the possibility of clarifying your authority with respect to foreign content. It will be several more years before we go through the Exim authorizing process again. I don't recall ever addressing that question in the exercises in the past, and I suspect that the law and the history are somewhat ambiguous on that.

Mr. MOORE. We did have a question raised on the House side last year in connection with our 90-day extension, and it was resolved without addition to our statutory language by our agreeing to report as a part of our semiannual report to Congress the amount of foreign content we have covered. So there was interest expressed on the House side in the context of being sure that we don't do much of this.

The way we do it is to allow up to 10 percent foreign content under our medium-term guarantee and insurance programs, but essentially none in our direct loan activities.

Senator STEVENSON. Well, to sum up, you feel that you have the authority and are competitive with respect now just to your counterparts abroad, with some exceptions in the cover area that you mentioned. I was struck by your reference to production subsidies and your suggestion that foreign countries are sweetening up deals with unrelated arrangements—we sell you the Airbus on very favorable terms if you will also buy nuclear reactors—that sort of thing, including you mentioned a reprocessing example.

Is this kind of thing a recent development and could you be a little more explicit about such things that foreign competitors are doing? Is it in response to the depreciation of the dollar? I don't recall much mention in our prior hearings on Exim of this problem.

Mr. MOORE. Mr. Chairman, I don't think it's specifically in response to or matching the cheaper dollar we have had in the last 6 or 8 months because it's been going on longer than that, but I think it goes back to something that was generally discussed by you and Mr. Weil, which is really an export fervor in all of our competitors.

Senator STEVENSON. And a fervor which picked up markedly in 1973 with the quintupling of the oil prices I assume.

Mr. MOORE. Exactly. I think it really dates from that time, and I think during that time resources have been poured into export credit financing and mixed aid credits to address the concerns of all countries with the problems of oil buying. As a part of that, as we discussed, there's a high profile within the Government structure of each of these countries for exporting and a very high officer of the Government will be available and the chief of state will act very vigorously. The French President doesn't hesitate to fly to Caracas on a special mission to get the Venezuelans to buy the Caracas subway from France. So there are many aspects to it other than just directly pouring money in or giving special concessions.

The Airbus has been one where you could almost say desperate moves were made in giving additional concessions in order to break into a market and to try to recapture some of the tremendous costs of developing that plane because initially they weren't successful in selling any at all. But I think we can anticipate in the future every kind of incentive being offered by the French and the Germans to sell the Airbus.

Senator STEVENSON. And you're not confining your comments to the Airbus?

Mr. MOORE. No. It's just that we have most definite evidence in that.

Senator STEVENSON. It's illustrative of what's going on in other countries as well as those?

Mr. MOORE. Yes.

Senator STEVENSON. Well, I hate to be a party to the escalation of this export subsidy and support war, but on the other hand, I don't believe in unilateral disarmament either. What should we be doing? We don't have a ministry of trade or a president who would or should hop around the world selling nuclear reactors.

Mr. MOORE. No; but we do have a chairman of the Eximbank who can and does.

Senator STEVENSON. As you just indicated, you're up against the chiefs of state of other countries who have authority to offer things that you don't have within your authority to offer.

Mr. MOORE. That's right, and I wouldn't for a moment want to be deemed as suggesting that we enter in any part of incentives in addition to matching the export credit financing. I wouldn't be a party obviously to offering nuclear reprocessing plant or even suggesting it or discussing it. We couldn't finance them anyway because we are not allowed to under our statute. But I do point out, Mr. Chairman, that our agency has a much higher profile around the world than it does in Washington, and in every instance where I have visited lesser developed countries, in almost every instance, I have been received by the chief of state and the highest level of attention is given, and I think we are not ineffective in that sense.

Senator STEVENSON. Well, I discovered that even your Senate overseer gets received by the chiefs of state at least of those states that are interested in credits, and most countries are desperate, of course, for credit, and that brings me to another subject—not another—it's very related.

International debt has roughly quintupled since the oil price hikes. Already rescheduling is taking place in certain countries. Credits are being sought by other countries that offer important marketing opportunities to us and great temptation not only to our exporters but also to our lenders who are looking for markets. Poland is an obvious example.

In many of these countries, particularly in the Third World but also in the nonmarket Communist countries, we and our competitors don't have access to the kind of information needed to assess credit in a reliable way. Isn't that true? Isn't the Eximbank in danger of getting more overextended in some countries and tempted, as are commercial lenders, to finance not exports but to finance the service of its own debt? Zaire and Peru are cases in point, are they not?

Mr. MOORE. Zaire certainly is. Peru is right up to schedule on repayments to us and could well make it through a very difficult period. It may not. Turkey is an example right now where it's a very difficult situation.

There are a couple things in your question. First, on the financial information available from the Communist countries, we have made strides in cooperation with the three with whom we deal—Poland, Yugoslavia, and Romania—to get information full enough for us to understand their real picture. It's not yet as much as we would like, but I think we do have a good understanding of all those three countries, which are the only ones with whom we are permitted to deal.

As to the overall world situation, there's no question, Mr. Chairman, that we are in a world where every country that's not oil and gas producing in a large way must plan in their planned economy or somehow struggle through if they are not on a very tight line because the only way to respond and conquer the problem is to increase your own domestic production, and the only way to do that is to borrow and build as fast as you can. If you're not prudent you will have trouble. Even if you are prudent, and you have unusual circumstances such as 4 years of bad harvests in Poland, you can face very difficult times indeed.

So I could not tell you that we won't have trouble in the next decade in a number of additional countries. I can tell you that we study the situation just as carefully as we can before we extend credit, and I can also tell you that over the years, while we have had many reschedulings, we have in almost every instance been paid out in full with full interest on the entire period of time the money was out. So I'm not pessimistic about the safety of our investments in the long run.

Senator STEVENSON. Well, it's awfully hard to talk with bankers on this subject because—nothing personal about this at all or implying anything about you—but I find international bankers striking very difficult notes in public and private about exposure abroad, and strong pleas for access to more information about the financial condition of foreign countries. Many of them, for example, suggest that with participations in IMF loans they might indirectly get access to the one source of information that does exist, the International Monetary Fund.

Let me put a proposition to you and see how you react. Wouldn't it be far easier to extend the credit wisely for the support of U.S. exports if countries throughout the world, the importers, were part of an international monetary system that could extend current account financing, could impose conditions and acquire information through such an institution as a world monetary fund and, if they were also members of a global monetary system that at least moved us toward currencies that were convertible?

Now before you answer let me also suggest to you that there are countries which, for political reasons, have been reluctant to enter our international monetary institution that exists, but for economic reasons now could be—if your answers to that proposition are right—persuaded to do so. Wouldn't Poland's membership, for example, in the IMF facilitate your business in the export of American commodities to Poland?

Mr. MOORE. Yes, Mr. Chairman. We would like very much to see Poland be a member of the IMF, and I quite agree with the thrust of your question that the greater the facilities available through the IMF or related kinds of institutions for helping in times of trouble, or helping impose politically unpopular conditions which have to be imposed in order to struggle out economically, the better we would all be in terms of lending to those countries. All of those are at the absolute heart of what you're talking about, and I think the addition of the Witteveen facility is terribly important to us in the coming years as well as to the countries that receive that facility.

Senator STEVENSON. Shouldn't the United States and the other major developed countries and the IMF itself be making a concerted effort to involve the world—enter the IMF or some variation of the IMF that made it perhaps politically easier for them to join, and are we doing any such thing?

Mr. MOORE. I'm not aware of that except in the case of Poland where, of course, we were warm in picking up and saying that we would like to see them join, and we would be glad to give support to their application. I'm not aware of the efforts generally otherwise.

Senator STEVENSON. I'm not either, and I think there ought to be one. And based on my own conversations abroad I think we might be surprised to find how much more receptive countries are to that invitation today than they were before the events of 1973.

Mr. MOORE. There's another aspect of your question which I'd like to address.

Senator STEVENSON. Convertibility?

Mr. MOORE. Yes, the repayment of credits. I think it would be a very fine thing both in terms of the front end competition and in the convenience and safety of repayment if export credits were repayable in some common currency like the SDR. Certainly then the quotes of interest rates on the front end could be analyzed in the same fashion and could be a good thing. I think we are a long way from getting something of that nature because of this intensely competitive time. I'm not sure the European community or the Japanese would think favorably of such an idea because many of them do have a stated interest rate advantage. The Swiss can offer very attractive long-term financing at private banks at well under 6 percent for long periods of time, up to 10-12 years, and the Germans similarly. So it would be unlikely that you would get agreement from those who have that kind of advantage.

Senator STEVENSON. Are you suggesting that the disorder in the money markets and the behavior of the dollar is creating uncertainties and barriers to U.S. exports?

Mr. MOORE. I rather think, Mr. Chairman, they work to our advantage. After all, the dollar is the most commonly used currency around the world and if a nation is looking forward to repaying a credit over the next 20 or 25 years, or 15 years, if there's a question of the Swiss franc or the volume available or the premium that has to be paid because of the shortness of supplies with the Swiss franc that probably works to our advantage from the point of view of the U.S. export. I can't document that but I think it's so.

Senator STEVENSON. The implication of Mr. Strauss' recent comments might not be entirely consistent with what you have just said. We'll have a chance to hear from him later.

Would you support special export finance incentives and assistance for U.S. industries facing particularly severe foreign competition? I was trying to get an example. Staff suggested steel, but steel has been out of the export business for a long time. It's too late.

Mr. MOORE. I could pick you up there. It may be too late on steel itself, but steel equipment supply companies are still very much in business and having a hard time and most of their business is export. I'm not suggesting that there needs to be special subsidies for them. There need just to be a normal kind of support.

Senator STEVENSON. Well, before you answer—those companies—maybe it's the shoe industry—that are facing severe competition, should they get special treatment from Eximbank and small businesses generally?

Mr. MOORE. Well, our business would be more related to the export of shoe machinery than to shoes. So it might be deemed to be counterproductive there, and we would be offering support for creating further capacity in the rest of the world. I'm not sure that I would see that any particular kind of industry in this country needs special subsidies in the sense of export financing. I think if we can match foreign competition on a reasonable basis that's sufficient. If you're talking about subsidies in the price of the goods, it's an entirely different matter. For example, the shipbuilding industry in this country, as far as I know, has never been able to win a bid abroad, so we have never had a financing of a ship of any great size, whereas there are very substantial subsidy programs for building of ships for the domestic freight lines. So one could look into that situation.

There are very competitive situations coming up on the chance to sell LNG tankers, for example, where if Congress wanted to consider supporting a depressed industry in the export business as well as domestically that would be something that could be examined here. Certainly nations abroad, as we understand it, have substantial subsidies for their ship building industries producing for export.

Senator STEVENSON. Well, that's another industry for which there's a great deal of overcapacity at the moment, although there may be as special exceptions such as LNG tankers.

Mr. MOORE. That's about the only one that you can see right now that's going to have much demand in the future.

Senator STEVENSON. Well, I assume you would agree that we shouldn't go out of our way to support industries marketing products for which there's already an oversupply in the world and we don't want to encourage more overcapacity. It would make more sense to support those that are developing products for markets that exist or can be developed, doesn't it?

Mr. MOORE. Yes, sir. My own belief is that we ought to serve commerce as it comes on as equal a basis as we can. We have got other issues, and steel is an example where, of course, at the present time the world has a great overcapacity and it's of concern to us when a lesser developed country decides to build a steel industry if it's a marginal decision in the first place. We would wish that there wouldn't be export credit competition which gets that mill built anyway, but rather a common advice from all countries to the potential buyer that maybe it would be better to wait 5 years.

Senator STEVENSON. Other countries are now offering inflation insurance and exchange rate insurance.

Mr. MOORE. Yes. France and England offer those and there may be some others as well. Italy introduced inflation insurance, but it was too expensive and was abandoned.

Senator STEVENSON. Is exchange rate insurance necessary in a floating exchange rate system?

Mr. MOORE. Well, it takes the risk out for the exporter being repaid in a currency whose value has diminished in comparison to his domestic currency.

Senator STEVENSON. Is that important? Should we be doing it?

Mr. MOORE. I don't think we should get into any of these programs, Mr. Chairman. They are too expensive. I would prefer at least for awhile to see if we can't continue to negotiate the other nations into abandoning those programs. Now we might have to address it if they keep on, but the programs are so expensive that I just wonder if they are going to be much of a threat to us in the future. I may be over-optimistic but I don't think so.

Senator STEVENSON. We are going to be meeting again so I'm not going to get into all of the more narrow Eximbank questions today. In this hearing we are aiming mainly at trying to find out what our friends abroad are doing in order to learn from them and if necessary to match them. I'm not sure I got your answer to my question about what, if anything, we should be doing to reorganize or to put ourselves in a better position to make the same kind of package propositions to other countries that our competitors do. You mentioned that the chairman of the Eximbank travels around the world, but acknowledge that he doesn't have the authority to do that sort of thing. Should be be doing something? Do we need a ministry of trade? Do we need some higher authority to travel and try to put these packages together?

Mr. MOORE. To the extent a ministry of trade would give higher profile to the interest of our Government and our people in exporting, I think it would be a good thing. I'm not aware enough of the organization of the different parts that would be pulled together to be able to comment on whether it would be an efficient operation once it's put together. I'm assuming that with the present expertise and reorganization, if that were done, it would be done well.

As I understand the proposal, Eximbank would be a part of it, but on a semi-independent basis. So I could see us very well participatinging in something of that nature.

There's an additional problem however. This export business cuts across so many departments—really almost every department of government—that by just putting together a ministry of trade which has a portion of Commerce, a portion of Treasury and State, or Eximbank doesn't include people from many other areas who are directly and indirectly involved in the export business of the United States—the Agriculture and the Defense Department, the Nuclear Regulatory Commission—all of those have important bearings. So whatever our organizational structure, I think a unified effort will help.

We have been trying to do that. We meet regularly, of course, with all of these different people at all levels to learn of opportunities and to try to figure new approaches that might help. If you're speaking most directly of the most effective tool for us to match what our competitors have abroad, of course you would be speaking of our coordinating with the AID agency, which is really not possible under the present structure of AID where the strong emphasis is to deal only with infrastructure in the poorest countries. I'm not critical of that policy—that sounds entirely right—but the chances are that if we were able to organizationally work together in time to make a competitive offer, if those problems could be overcome, still the point where we could meet under the present policies of the two organizations would be very infrequent. So I don't think we have available to any measurable extent an opportunity as things now stand for offering mixed aid credits. And, again, I would hope that the United States, through a lot of different discussions on all levels, would talk to the other nations of the world and the United States itself into a unified position on AID credits.

Senator STEVENSON. Let me make sure that I understand this. Do you think there is no need for mixed AID credits? Or were you saying that there is no mechanism for Exim and AID to cooperate for the development of packages?

Mr. MOORE. No mechanism. If we were going to be fully competitive with some of the other export credit agencies abroad, of course we would have to have a mixed AID capability.

Senator STEVENSON. Wouldn't that be desirable? Even though it is not going to turn into something very large, why not do it, for whatever incremental benefits may flow?

Mr. MOORE. If we are going to negotiate successfully with our competitors abroad, if we don't have that capability, whether or not used, we are not going to be successful.

Senator STEVENSON. Shouldn't we take whatever steps are necessary to create that capability for ourselves?

Mr. MOORE. I think it would be wise. There are many political questions involved. But if we are going to succeed in getting our competitors abroad, and they are mostly friends, to stop the practices we have so far, we are going to have to be able to say the United States is going to match.

That is the most effective way to get to the bargaining table. We can't do that now.

Senator STEVENSON. I think it might also help to dispell some of the myths about AID. It is regarded as a big give-away by the public. It is largely a poor man's Eximbank. The dollars are spent in the United States, most of them.

Do you have any thoughts as to how that capability could be developed in the United States?

Mr. MOORE. Well, you would have to vote funds to make them available, and presumably you would administer them one place or another. Or you would make a special fund available to the Eximbank itself, in order to match competition, where we could extend loans that average 18 or 20 years at 6 percent interest, rather than having to be on a straight commercial basis.

Senator STEVENSON. I was thinking of some institutional way of making it possible for AID and Eximbank to package financings with their proper authorities.

Mr. MOORE. Let me address that, because the present approach at AID is not just to be a poor man's bank. It is also to be the poor man's world bank, because these projects are carefully studied, worked on for maybe an average of 2 or 3 years, before they are implemented. Eximbank, in almost every situation, is responding to requests for international tenders within 60 to 90 days, and if we didn't have AID credit to offer at that point, we couldn't operate. So the operations of AID itself would have to be redesigned to the extent that you are considering the financing of components in projects, rather than projects as a whole. This is not to say that we do not also occasionally work on very large projects for a long time, and have a formative effect on them, but those are not paramount in the whole picture.

Senator STEVENSON. Let's do some more work on that. Maybe we can be a little more precise when we get to the Eximbank authorization.

One last question, Mr. Moore. Roughly how many additional jobs are created in the United States with each incremental million dollars worth of exports?

Mr. MOORE. If I may quote a billion dollar figure, we tend to think of 40,000 jobs, per billion dollars. I think that is a conservative number. The estimates depending on the kind of product produced. We use 40,000; some institutions use 60,000 or even 70,000.

Senator STEVENSON. 40,000 sounds conservative, for each billion dollars.

Mr. MOORE. Yes. That is $25,000 per job.

Senator STEVENSON. Have you read Humphrey-Hawkins?

Mr. MOORE. I have not yet, but I certainly will.

Senator STEVENSON. I urge you to do so fast.

Thank you very much. Our next witness is Robert Hormats, Senior Deputy Assistant Secretary for Economic and Business Affairs, Department of State.

STATEMENT OF ROBERT D. HORMATS, SENIOR DEPUTY ASSISTANT SECRETARY FOR ECONOMIC AND BUSINESS AFFAIRS, DEPARTMENT OF STATE

Mr. HORMATS. Senator, briefly, I would like to make a number of points on the general cimate as it affects exports, since I noted that your letter quite corectly pointed out the distinction between policies and programs to support exports.

In a very broad sense, our expert performance is determined most importantly by the level of growth in our major trading partners.

And in the world today, where many of our trading partners are experiencing very slow growth, we have, I think, as a result achieved a lower rate of increase of exports than in previous years.

I think that the cyclical factors, the low growth in these countries relative to a slightly higher growth rate in the United States, has amounted to roughly two-thirds of the present U.S. deficit.

A second factor is the nature of the international trading system. Obviously a flourishing trade system, a relatively open one, is a major requirement for flourishing export markets for the United States. We have done, and most other countries have done, in the face of very real domestic pressures, reasonably well in keeping markets open. I think this has been a plus for our export performance.

A third key element is the attitude of American firms. And I think as my written testimony points out, other developed countries have, over a period of years, invested a great deal more time and energy and talent in building export markets. And without this psychology among the private sector participants, no export promotion scheme in itself is going to be overwhelmingly successful.

On the other hand, coupled with a positive attitude on the part of firms, export programs can be useful in acquainting people with the opportunities in the market—and I think we could probably be doing a good bit more on this, particularly in developing new opportunties in developing countries——

Senator STEVENSON. By "we", do you mean the State Department?

Mr. HORMATS. The State Department, the United States in general, yes. In part because these are new markets for Americans. By and large, I think to the extent they have exported, they are more acquainted with Western Europe in particular.

Senator STEVENSON. Are "we", meaning the State Department, going to do more?

Mr. HORMATS. Yes, sir, we are in the process of doing that, and a number of new institutions have been developed and put into place in the developing countries. That is a major new thrust of our export promotion effort. Because the largest growing markets for American imports are in the developing countries already, and it is particularly important that United States anticipate the probabilities that these markets are going to grow in the future.

Senator STEVENSON. You say "we", the State Department. Are "we," the Commerce Department, the Eximbank, the Agriculture Department, are we all going our own way on this development?

Mr. HORMATS. No. I think in the overall effort that we are making, there is a major effort to cooperate between State, Commerce, and all of the various agencies that are involved in the export promotion field.

There is no question about the fact that we, the State Department, really involve ourselves for the most part in the external side, across our borders.

Senator STEVENSON. So do they.

Mr. HORMATS. They do, too. But Commerce's major advantage is that they have the various district offices in the United States, making businessmen aware throughout the United States of the growing export opportunities in the developing countries. And in the developed countries, of course, too.

Senator STEVENSON. Well, they are all over the world today.

Mr. HORMATS. I understand that, sir.

Senator STEVENSON. In fact, you have just heard the chairman of the Eximbank talk about how he hopped around.

Incidentally, his agency doesn't have nearly as many offices overseas as his counterparts do. I just wonder whether we should not be giving some thought to institutionalizing this presence abroad in a way that would be coordinated, be more efficient, and the dollars that are available for such activities would be used more efficiently?

This administration is reorganizing everything else. Is it reorganizing these external export promotion activties? Is there a PRM on that, too?

Mr. HORMATS. There has not yet been.

Senator STEVENSON. Maybe that is one place there should be one.

Mr. HORMATS. Well, the State Department and Commerce Department, along with other agencies which have an interest in exports, have been working very closely, even without a PRM, to try to anticipate the new opportunities in the market and take advantage of the best domestic and international network which exists to be more responsive.

Senator STEVENSON. Please continue. I am sorry to have interrupted you.

Mr. HORMATS. Well, the overall climate then I think is a key element as to the degree to which United States is going to achieve success in the exporting market.

The point that you raised in your letter, which relates to the performance of other countries, is particularly interesting from our point of view, as we have followed particularly closely in the last year or so the cases of Germany and Japan, which have been extremely successful in exporting.

We thought we would, of course, look into this and determine why, that maybe we could learn a few lessons from them.

The major lesson that I think we have learned is that again they have very active firms which have made a practice over a long period of time of building export markets.

In the Federal Republic of Germany, the degree to which support is provided by the Government, is rather slight. The support mainly comes from the privately sponsored German Chamber of Commerce.

In Japan, the situation is quite different. After the war, the Japaneses focused on developing several leading industries. The Government and the industries worked together with the banking system, to provide a considerable amount of capital to build these industries. The industries have been built up primarily on the basis of the growing internal Japanese demand, but, over time, recognizing the national interest in exporting in order to import the vital raw materials Japan needs, they have also moved very aggressively in a number of areas in the export market.

By and large, though, the export promotion activities of the Japanese Government today are much more limited than they were a number of years ago. Roughly $44 million was allocated by the Japanese Government in fiscal year 1976 to the promotion of exports. Roughly two-thirds of that went to JETRO, which is the Japansese External Trade Organization, which provides information to Japanese firms on activities and opportunities in other countries. It helps them do the necessary market research and centralizes, in one rather tightly organized vehicle, the information process which enables firms to understand better how to move into the foreign markets.

I might also add that one major change is that JETRO is now turning some of its energies to helping other countries import into the Japanese market, which is a welcome development. And this is perhaps another area where we could learn from their practices.

Senator STEVENSON. Do we need a JETRO, that focuses on opportunities in external markets?

Mr. HORMATS. Well, we do that to a large degree with the cooperation between State and Commerce, which provides the same sort of flow of information. I must say I am not as familiar with JETRO as I would like to be, particularly the more detailed techniques that they use to do these sorts of things.

They have been very successful, and I think that we ought to take a closer look at just how the programs work.

In theory, what we do and what JETRO does is very similar. In practice and in detail, I simply don't know the answer, but I think we ought to look very carefully at it and see what we can gain from it.

Senator STEVENSON. I agree with that.

Mr. HORMATS. Another interesting point that was raised in your letter, and one we have been looking at in some detail within the context of multilateral trade negotiations in particular is the report promotion practices of developing countries.

By and large, the developing countries, as you pointed out earlier, are becoming much more competitive internationally, not only in the more traditional labor-intensive products, but also more recently in highly capital-intensive products, and steel is a good case in point.

These countries use a variety of subsidy practices, in part justified by the so-called infant industry argument, to help the smaller firms to get a foothold in the international market. They also use a number of subsidies to attract firms, to attract foreign capital, to get people to invest in those countries in the first place, and perhaps to stimulate development in the poorer areas of those countries in particular—a method also used by developed countries, I might add.

So far, the subsidy practices of the developing countries have not, except in a couple of instances where there are countervailing duty cases, been an overwhelming problem for the United States or for other developed countries.

In the future this may be a more difficult problem as they get a foothold in the market. I think this is something we are going to have to look at very carefully. And this is one of the major reasons we are putting such attention on the area of subsidies and countervailing duties in multilateral trade negotiations: to try to anticipate this problem and to develop codes and rules and understandings which will mitigate the difficulties we anticipate in this area, as well as deal with problems which currently exist.

With respect to the European Community, another point you raised, there really are no Community subsidies for manufactured goods, or Community export promotion programs for manufactured goods. There is the well-known problem of the value added tax (VAT). A case going to the Supreme Court now concerns not the VAT, but a similar cae of restitutions of indirect taxes, but we do not sonsider there to be export subsideries.

But with respect to export promotion, there is no Community-wide program. Individual countries in the EC however, do have their programs. They have a variety of programs.

In reading over the statement that Mr. Hammer is going to give, I noted a list of tax incentives for exports by these countries. There are a range of national export promotion incentives, ranging from Germany, which has almost none, to some other countries which have invested a great deal in export promotion. Great Britain, for instance, has, over a period of time, invested a great deal of talent in promoting exports, and I think that is a case which illustrates the importance of a thriving and productive domestic economy as a prerequisite of exporting. Britain with a large investment in the export area, has not done as well as Germany, which has invested very little in export promotion. That is a lesson that indicates that without the fundamental prerequisites, spending a lot of money on these programs will not necessarily achieve great success.

Senator STEVENSON. But it is sort of a chicken and egg situation, isn't it?

Mr. HORMATS. I think with respect to the Germans, the reason they have done so well is primarily they have kept on top of the market, they have anticipated the needs of the market, and have an economy which has met the needs of potential consumers of German products, without a great deal of export promotion per se. In other words, the companies have been their own best promoters.

With Great Britain, it is no secret, that they have had a relatively difficult time with respect to British export for a number of reasons which have more to do with domestic economics in Britain.

In conclusion, very briefly, the point I made earlier is that there are a number of factors which determine the success of a country and its ability to export. Among them, of course, are the export promotion programs and export financing, but by and large, the key determinant is the willingness of firms to anticipate market opportunities and to invest the required amount of time and attention and management talent to promoting these.

I think that all of these policies go hand in hand with one another, in improving the international climate, thereby increase the incentives of individual firms to go out and export.

I know, for instance, that the decline in value of the U.S. dollar will improve the competitiveness of certain American firms. Our productivity in a number of areas is also improving relative to some other countries. This should improve opportunities for firms.

So I think American competitiveness is by no means lost and we have not, contrary to some cries of doom and gloom, lost our international competitiveness. In a number of markets, our shares of the market has, in fact, increased. But I think it is going to require proper management of the international economy, proper management of our domestic economy, along with the sorts of programs on which we are focusing today if we are going to have a thriving export picture in the future.

[The complete statements of Mr. Hormats follows:]

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Statement of Robert D. Hormats

Deputy Assistant Secretary for Economic and Business Affairs

I am pleased to have the opportunity to discuss with this Subcommittee the policies and programs of the United States, and of other nations, to promote and expand exports. Let me begin by making a few general comments that will help to place in perspective the testimony that follows:

Introduction

Concern about U.S. trade policies has increased in recent months because of the significant U.S. trade deficit of over $31 billion in 1977. The principal reasons for this deficit are twofold: (1) our massive oil import bill and (2) the slow growth of U.S. exports due largely to sluggish economic activity in our major foreign markets. U.S. imports of petroleum increased by 31% from 1976-77; imports of all other products increased by only 18%. U.S. exports grew by 5% in the same period as compared to an increase of 7% in 1976 and 9% in 1975.

My testimony today is, of course, not directed towards the oil import problem, but no discussion of trade can ignore the fact that our oil deficit, in the absence of an effective national energy policy, will have a major adverse impact on the United States trading situation for years to come.

Nor am I primarily concerned today with the question of imports, except to point out that, except for oil, they have grown this year at a rate roughly the same as in earlier years and in the aggregate have not sharply increased. The U.S. has a remarkably stable economy with a high propensity to consume, a good distribution system, a solid record of economic growth and relatively few barriers to imports. It will understandably remain a growing market for competitive goods produced at home and abroad.

My objective today is to respond to Senator Stevenson's letter of February 8, 1978 to Secretary Vance, which asked a number of important questions regarding the policies used by of this government to support export expansion, and the practices of other nations to do likewise.

Let me begin by stating categorically that the United States today is extremely competitive in international markets. But our exports this year are not doing as well as hoped. There are several reasons for this.

First, many of our major developed country trading partners are suffering from slow economic growth. This limits their demand for our exports. Lagging international investment is partly responsible for their slow growth, and because we are a major exporter of capital goods we have been particularly affected.

Second, good harvests abroad have reduced the expected demand for U.S. agricultural products in some countries.

Third, many of our leading developing nation markets are suffering from slow growth, in some cases because they are undertaking stabilization policies to reduce inflation. However, except in a few OPEC countries where our previous share of the market may have been unsustainably high, America's relative share in individual developing country markets has not declined significantly. In some individual developing country markets the U.S. share has actually increased. We can trace the reduction which has occurred in our share of developing country markets to the fact that our best developing country customers have recently experienced a slower rate of growth than the developing countries which are the major markets for some other nations, in particular Japan.

Apart from these cyclical factors, there are structural economic, and psychological considerations affecting U.S. exports. Why, for example, do the British and the Germans export 25-30% of their GNP compared to our 7%? The answer can be expressed simply: the size of their domestic markets makes it important for them to export in order to sustain a highly sophisticated, diversified industrial base. Exports are an economic necessity for these countries. This has obviously not been the case for the U.S. Our massive domestic economy is large enough to sustain our industrial capacity in most sectors. It is therefore not surprising that, in the past, exports have been looked upon by many U.S. companies as "icing on the cake". In good times, when domestic demand is high, our manufacturers often pay too little attention to export opportunities. They are producing virtually all they can for domestic consumption. When domestic demand declines, there is a greater tendency to look abroad for sales, but unless firms have carefully cultivated their foreign markets, it is often difficult to find ready buyers on short notice. In addition, American firms sometimes find it difficult to justify the expense of changing production runs to meet foreign needs and specifications, especially when foreign sales are likely to be a relatively small proportion of domestic sales.

The attitude of U.S. firms toward exports is extremely important. No matter how active the U.S. Government is in promoting exports, there is no substitute for the willingness of American companies to compete in international markets on a sustained and active basis. Many do, and have done exceedingly well as a result. But many have not yet made the necessary commitment of effort or resources.

The recent depreciation of the dollar against a number of currencies should make it more attractive for many U.S. firms to make such a commitment. The dollar's decline has made American products more competitive in certain markets. In addition, production costs in manufacturing in the U.S. have decreased since 1975 by about 5% on average vis a vis costs in our OECD trading partners. In view of these developments, an investment of time and talent in export markets can be well rewarded in many sectors.

The U.S. Government can help by familiarizing American firms with export opportunities and by facilitating their efforts to take advantage of them. Evidence of a high level of commitment within this Administration to this objective is President Carter's message of January 19, 1978 to all U.S. Ambassadors. It stated that: "Trade expansion is particularly important at the present time. Sales abroad are needed to reduce unemployment and restrain protectionism at home, and to improve the nation's balance of payments. I ask that you, as my representative, ensure that a high priority is placed on the trade expansion and other commercial programs in operation at your embassy."

Let me now turn to the U.S. export promotion program, which is intended to give effect to this commitment and to these objectives.

The U.S. Export Expansion Program

The U.S. export expansion program is a coordinated interagency effort. Policies are jointly formulated by the Departments of State and Commerce.

Domestically, the Department of Commerce and its network of 43 district offices work directly with U.S. firms to assist them in their exporting efforts. Abroad, the more than 200 diplomatic and consular missions of the U.S. Foreign Service comprise the program's overseas action arm. The export credit, loan, and guarantee programs of the Export-Import Bank and the insurance programs of the Foreign Credit Insurance Association complement the export promotion activities of Commerce and State.

In carrying out its export promotion responsibilities, the State Department performs five broad categories of functions:

-- We provide Foreign Service Officers qualified in economic and commercial affairs to conduct export promotion programs. The State Department has roughly 900 economic-commercial officers, 300 of whom are fully or principally engaged in commercial work. These officers work in the Department and in our Embassies, Consulates and Trade Centers abroad.

-- We provide our overseas posts with guidance and assistance in managing their individual export promotion programs. Thrity-seven Embassies in major commercial markets abroad operate under a State-Commerce annual plan called a Country Commercial Program. This management-by-objective document establishes plans and programs for efficiently utilizing our commercial resources to achieve specific goals. Additional Embassies in smaller markets target their activities and manage their resources under a simplified type of annual plan called a Commercial Action Program.

-- We coordinate with other U.S. Government agencies to ensure effective export promotion assistance for the American business community. For example, information collected at Foreign Service posts is distributed in the U.S. by the Department of Commerce.

-- At our posts overseas we assist visiting American businessmen to establish appropriate trade contacts and to resolve any commercial problems they encounter.

-- We assure that all activities undertaken under commercial programs are consistent with overall U.S. foreign policy objectives. This is achieved through frequent interagency meetings among senior officials.

The commercial activities performed by the U.S. Foreign Service are aimed primarily at assisting firms to enter and expand their markets abroad, giving special attention to the needs of small and medium-sized companies. Foreign Service posts provide these firms, through Commerce, with a continuing flow of reports on economic trends and market developments, market research, trade opportunities, major economic development projects, and background financial and commercial information on prospective agents, distributors and purchasers of American products. In addition, the posts actively help organize and promote U.S. trade and industrial exhibitions abroad. They also arrange for foreign buyers to come to the U.S. to visit American trade shows and visit American firms.

Our posts abroad also operate commercial libraries and publish and distribute commercial newsletters to provide the most important business and government buyers, agents and end-users with current information on American products, services and technology. These activities are, of course, in addition to the posts' ongoing assistance to visiting American businessmen and to the resident American business community.

In its scope, geographic coverage, and quality, the U.S. export expansion program compares with the best in the world. It is designed to enable the U.S. Government to provide the information and assistance needed by private industry to undertake its own successful initiatives in the international marketplace. We are constantly seeking improvements in effectiveness and efficiency. Together with the Department of Commerce, we regularly review and evaluate our commercial programs. We also undertake joint annual reviews of our overseas commercial staffing to make certain we are allocating resources appropriately to achieve our export expansion objectives.

To further improve our export promotion programs, a joint Commerce-State inspection team last year recommended a number of important changes in our commercial programs and activities that both agencies are in the process of implementing. These were reviewed and discussed in March, 1977 by a subcommittee of the House Committee on Government Operations. The Committee's report (No. 95-576) gave added impetus to these recommendations in addition to presenting its own findings and conclusions.

State and Commerce have endeavored to be responsive to the recommendations of the State-Commerce inspection team and of the House subcommittee. For example, a new and more flexible approach to trade promotion is being developed to assist American firms to merchandise their products at major international trade fairs. The new International Marketing Centers, now located in Germany and Singapore, and soon to be established in France, Italy and Australia, will provide the backstopping for this new effort. In addition, the Inspection Team called for improvements in State-Commerce coordination of commercial activities through regular meetings between senior officials of both Departments. These meetings have been initiated, and State and Commerce have either already implemented or are in the process of implementing many of the other major recommendations of the Joint Inspection Team and House subcommittee aimed at improving our export promotion programs. To help American businessmen better understand the assistance that is available to them from the State Department and the Foreign Service, State will soon publish a brochure to supplement material already available from Commerce.

We are also learning from our competitors. For example, we have adopted the British "automated trade opportunity system" whereby domestic firms swiftly receive computerized trade leads from Foreign Service posts on a subscription basis. From the British, Canadians, French and Germans, we have learned the value of encouraging potential buyers to visit the U.S., although we do not subsidize their travel as some of these nations do. From the Japanese we have learned the importance of careful market research and targeting of markets, so that we can bring both government and private resources to bear in promoting the sale of products which appear to have good sales potential. And from our own private industry, we have learned to apply management-by-objective techniques to our commercial efforts.

Comparisons of the export promotion programs used by other nations are difficult and complex. Recent studies by the Department of Commerce and Congressional Research Service of the Library of Congress, which are based upon reports submitted by our Foreign Service posts and which address this subject of competitor nation export expansion programs, can be provided separately to the Subcommittee.

Our review of these programs has convinced us that we can learn still more from the commercial activities of these nations. We intend to explore with the Department of Commerce the possibility of adapting certain of the following promotional techniques our competitors have found successful:

-- More extensive market research, either free of charge or by funding a significant share of the cost. One nation offers a "product exportability diagnosis" for new-to-export manufacturers;

-- Pay a greater share than we do of a company's cost of participation in a government-organized trade fair, trade mission, or trade center show abroad.

-- Fund reverse trade missions and factory visits of carefully selected foreign buyers.

-- Obtain the assistance of larger firms well established in overseas markets in providing guidance and perhaps warehousing facilities for non-competing smaller firms wishing to enter the market.

The Role of Export-Import Bank

The Export-Import Bank is an important instrument in our overall export efforts. As a part of this administration's positive approach to export expansion, the Eximbank, during the first quarter of the current fiscal year, has already made direct loan commitments to the extent of $760 million compared to $700 million for all of FY 77. The bank's immediate goal is to support at least $12 billion in annual exports from the U.S.

I want to examine how the programs which the U.S. Export-Import Bank (Exim) offers to finance and facilitate U.S. exports compare with similar programs abroad. Exim is required by its statute to provide its loans, guarantees, and insurance on terms competitive with the government-supported export credit programs of other major exporting countries. The Bank is, however, limited in two ways in its efforts to be competitive.

First, as a self-sustaining institution, not supported through government budgetary outlays, Eximbank must take into consideration "the average cost of money to the Bank". In individual transactions it could lend funds at rates below its cost of money, but over the longer term it has to set its rates sufficiently high to enable it to pay its own way. Second, Eximbank is instructed "to supplement and encourage, and not compete with, private capital." The greater the extent to which Eximbank lends on terms more generous than those offered by commercial banks, the greater the risk that it will in fact compete with private capital.

Exim is not, however, required to compete with export financing available abroad which is not government supported. This is an important point, because at times market interest rates in some countries will be well below Exim rates and market rates in the United States. I doubt that it is feasible or desirable for Exim to try to offer rates competitive with private rates in such countries.

Exim says of its competition in its latest report to the Congress that, "Eximbank believes that it offers long-term financing support similar to--but not truly competitive with--that available from France and Japan and is basically competitive (except for some ancillary forms of support) with that available from all other major official export credit agencies." In the medium-term financing area, Exim believes it is "generally competitive...but still on the high-cost side...." Exim believes that its insurance and guarantee programs "are generally comparable to and competitive with" those of its competitors.

I would like to add to this several thoughts.

First, the great diversity of different countries' systems of export credit makes comparison among them difficult. However, it appears that we have not officially supported as large a share of our exports as some of our major competitors. Looking only at direct and discount loan authorizations during 1976--that is, excluding guarantees and insurance--data collected by Exim indicate that Canada provided $728 million; the U.K., $1.2 billion; Italy, $1.5 billion; the U.S., just under $2 billion; Japan, $3.3 billion; and France $7.6 billion.

Second, interest rates in different countries are determined by a number of factors. In some cases where Exim's rates appear uncompetitive, this may be offset by the likelihood of future appreciation of the competitor's currency with respect to the dollar. This increases the real cost of a loan in the competitor's currency.

Third, the export credit consensus--internationally agreed guidelines to cover the export credit practices of Exim and similar agencies abroad--has as its objective the reduction of wasteful official export credit competition among the major noncommunist exporting countries. It contributes to the accomplishment of this objective by, for instance, establishing guidelines for minimum interest rates and other conditions of export credit transactions. The minimum interest rate of the first consensus caused some adherents to raise their rates, thus enhancing Exim's relative competitiveness.

In the new arrangement agreed to in February, which will replace the present consensus, several features were improved. The new arrangement, for instance, spells out important conditions of transactions--interest rates, cash payments, and repayment terms--in sufficient detail to close existing loopholes. Further, it provides greater "transparency" or knowledge regarding derogations or prior commitments of other export credit agencies. This will help Exim to offer more competitive financing while at the same time lessening the risk that excessively generous terms will be offered. In these ways the new arrangement should serve to strengthen further Exim's relative competitiveness.

We believe continued efforts to strengthen the arrangement are the best course to follow to ensure Exim's competitiveness. In the meantime, Exim has recently begun to offer its direct credits--with their fixed interests rates, in contrast to the floating rates usually offered by U.S. commercial banks--for greater percentages of the total cost of U.S. exports in individual transactions. Exim has also begun to lower some of its interest rates (in conformity with its statute and the consensus), to lengthen repayment terms, and to provide some local cost support. These steps should further improve its relative position.

27-039 O - 78 - 5

Impact of Changes to Internal Revenue Code on U.S. Competitiveness Overseas

Section 911

It is not only our direct export promotion programs which can have a significant impact on the ability of American companies to sell their products and services abroad. Tax considerations also play a role. Amendments made in 1976 to Section 911 of the Internal Revenue code significantly increased the tax liability of U.S. citizens working overseas. The State Department has received numerous reports from our Embassies and directly from U.S. firms that many Americans will have to give up their overseas jobs because of the tax increase. The loss of American jobs overseas will have an adverse impact on unemployment in the United States, will cut our service income from abroad, and will hurt our exports. The GAO has recently concluded a major study of the impact of these tax changes. In its report submitted to the Congress on February 21, the GAO said that 88% of the many U.S. business officials interviewed were of the opinion that the tax changes would result in a least a 5% reduction of U.S. exports. In 1977, a 5% reduction would have cost the United States $6 billion in exports.

On February 23, at hearings at the Ways and Means Committee, the Administration proposed several changes to the rules on taxation of Americans working outside the United States. We believe these proposals provide fair and workable rules which take into account differing circumstances encountered overseas. This system will make American workers more competitive internationally and will thus help American companies maintain and expand their foreign markets. We are presently the only major trading country which taxes the foreign earnings of its citizens. We must make sure that this taxation does not cripple the ability of American businessmen to compete in foreign markets.

Germany and Japan

I would like now to turn to the export promotion efforts of two of our major competitors, Germany and Japan, to explore some of their techniques.

Since the industrial revolution, it has been clear to German leaders that a high level of exports was essential to continued industrial growth and prosperity. After the second world war, German industry was rebuilt with the most modern technology and capital equipment available. The results were predictable: high productivity, solid design and engineering, and the rapid re-establishment of a world-wide network of agents, dealers and service centers. These, coupled with an energetic and disciplined labor force, imaginative and capable management, and a largely unfettered free enterprise system, brought about the German economic miracle.

Exports were given further impetus by a German mark that was undervalued during the first two decades after the second World War. This enabled German products to compete very effectively in terms of price in international markets. Revaluation of the mark and rising costs in Germany have caused prices for German goods to rise significantly during the past few years. But the export base had already been laid. Overseas dealers were in place. Many foreign buyers were and are convinced that German engineering, on-time delivery and after-sales service were unbeatable. The price of German products was often a secondary factor. Exports have therefore continued to increase.

Given such a dynamic economy and energetic private export efforts, the German government's export promotion program has had relatively little to do with German success in foreign markets. Official trade promotion efforts are largely peripheral to the achievements of private industry.

They are designed to facilitate the efforts of business, essentially through industry's own resources. Trade associations and German Chambers of Commerce in overseas markets undertake market research for German firms, usually on a reimbursable basis. Advice and guidance on how to enter an overseas market is freely given by the Chamber to German firms new to the area. The same Chambers provide assistance to foreign firms that wish to enter the German market by providing marketing information, business contracts, trade leads and the like.

Policy guidance to the Chambers is provided by German diplomatic staff abroad; however, most of these officers devote their time primarily to economic analysis and reporting. A small domestic staff coordinates German participation in international trade fairs, but the German business community is the major force in initiating and managing such participation.

The lesson to be learned from the German experience is that government assistance, as helpful as it may be at times, is less important than the existence of an export-oriented business community that gives high priority to producing products in demand abroad, vigorously goes about merchandising these products, builds a well organized network of overseas dealers and agents, and provides on-time delivery and good after-sales services to its foreign customers.

Japan

The relationship between exports and growth in Japan is frequently overstressed and oversimplified. Granted, Japan's almost total lack of raw materials requires it to import vast quantities of vital commodities. There is a corresponding awareness of the need to export in order to finance these imports, and a special concern about exports when, as in 1973, 1974 and 1975, Japan had a trade deficit. Nonetheless, Japan's exports as a percentage share of GNP amounted to only 14% in 1976, up from 12% in 1970. Japan's dependence on exports is consequently far less than that of many other countries. During this six year period Japan's GNP has grown in real terms by about 28%. Clearly, more lies behind this large growth in Japanese GNP than the 2% change in dependence upon exports.

A key factor in Japan's economic success has been its industrial policy. After the war, the government selected key industries--notably heavy industries and chemicals--as essential to national development. These, and a few others selected later (automobiles in the 50's and computers in the 60's) received favorable government treatment, including protection from import competition. Because Japanese corporate financing relies heavily on borrowed rather than equity capital, the Bank of Japan has been instrumental in channeling funds to favored sectors. These sectors have thrived; many are now exporters and indeed have predicated their expansion on growing export markets. Some of the big industries initially received export incentives, but these have been phased out.

The collaboration between government and industry takes place in a uniquely cooperative spirit. For example, even the most favored sector is not exempt from environmental controls, but the decision to undertake the controls and the mechanisms for enforcing them are worked out in advance through long and patient negotiations. For instance, the Japanese auto companies and the government worked out an environmental standard and a timetable which allowed implementation without severe economic dislocations or uncertainty.

Antitrust and anti-monopoly practices in Japan differ significantly from those in the United States. The Japanese Government does not view competition as essential but rather as one of a number of industrial policy tools. Enforcement of the law allows a degree of selectivity, and there are special exemptions in the national interest. Export cartels are common. The Japanese have taken the view that, as trade is liberalized, domestic companies must be large enough to be competitive with U.S. and European firms.

The direct export promotion efforts of the Japanese government are shared among a number of ministries, including the Ministry of Finance, the Ministry of Foreign Affairs, and, most notably, the Ministry of International Trade and Industry (MITI). MITI has the principal role in trade promotion policy.

For fiscal year 1976 the MITI budget for export promotion activities was $44.5 million, almost exclusively concentrated on manufactured goods. (In this country, the Departments of State and Commerce spent approximately $41 million.) Of this total about $500,000 was used to encourage firms to export, $14 million was allocated to economic and trade research, information services and support for export associations. The balance, $30.4 million, was direct support for the Japan External Trade Organization (JETRO), which has semi-autonomous responsibility for most export development activities. The MITI subsidy is 48% of JETRO funding. The rest comes from local governments and dues paid by nearly 5000 firms and organizations affiliated with JETRO. The functions of JETRO are not all export related, however. Import development and assuring raw material supplies account for some of JETRO's activities.

Initially founded to assist small and medium-size firms in becoming more export-oriented, JETRO is now much more active in assisting the various Japanese trading companies. It is in the early exchange of information about potential markets that a great deal of JETRO assistance is provided. JETRO will undertake a study of a particular market, outlining standards, special requirements, or other market information and then make such a study available to all potential firms.

New-to-market firms, or domestic companies seeking to export would in all likelihood be referred to the trading companies rather than encouraged and assisted in their efforts to go it alone. The trading companies in turn provide unique advantages to these and established Japanese exporters. In smaller export markets, a single firm can supply almost any product that a customer desires. Service is quick (as a result of highly developed communications networks), but efficient (because of coordinated scheduling), and low cost (because trading companies are low-margin high-volume traders with in-house banking and credit services).

However, where there are large markets for specific products, producers will often bypass the trading companies and establish their own sales and distribution operations. Autos and TVs in the United States are examples. It should be added, of course, that the major export successes of Japanese firms are the result of the skills, energy and commitment of time and personnel of the firms themselves. It is they who must design, sell and service products effectively enough to convince people to buy their goods. Government support is helpful but not the key factor in determining export success.

While the Japanese economy at home is not as strong as its extraordinary export performance would have us believe, Japan's competitiveness has reached the point at which it should feel more comfortable about permitting greater access for imports from abroad. Increased access to Japan's market will not dramatically increase imports overnight, but reductions in tariffs and non-tariff barriers, and improvements in the internal distribution system, will be important steps in the right direction and will contribute further to Japan's internal and international success.

The recent Strauss-Ushiba agreement demonstrates that Japan will participate more fully and positively in the international trading system and intends to play a role commensurate with its influence on the world economy. A joint U.S.-Japan effort has been organized to bring Japanese buyers to the United States. We and the Japanese have also established a Joint Trade Facilitation Committee to consider problems of U.S. exporters whose products face difficulties in entering the Japanese market. A Joint Study Group is also identifying new export opportunities.

Japan is a good ally, a solid friend and an important economic partner of the U.S. Our trade problems are being dealt with in this context. They should not, however, be expected to go away as the result of one declaration or policy action but as the result of a series of steps taken by Japan in close consultation with her economic partners, to improve access to and growth of the Japanese economy and to strenghten the world economy, on which we all increasingly depend.

The European Economic Community (EC)

This Subcommittee also asked about the European Economic Community. One of the major reasons for the establishment of the European Community was, of course, to promote trade among its members by eliminating tariff and other barriers within the Community. To a large degree, this goal has been accomplished. At the same time, the growth in economic prosperity within the EC has made the Common Market one of the largest consumers of goods produced in other areas of the world, including the U.S. In 1976, for example, EC countries imported approximately $343 billion worth of goods, with about half originating outside the Community and half resulting from internal trade. Thus, while providing a ready market for goods produced by its member nations, the EC is a major and growing importer of goods from countries outside the EC and is a positive factor in the growth of world trade.

The existence of the European Common Market by definition promotes trade among its members. The major factor, of course, is the elimination of tariffs within the community. Italy, for instance, can export to Germany without payment of customs duties, border taxes and the like. In addition, the members of the Community enjoy close traditional economic links, which facilitate shipping and servicing of goods, and make it relatively easy to establish international dealer networks within the Common Market.

Another factor has been the growing harmonization of standards within the community, a development which also makes it simpler for both EC member states and outside countries including the U.S. to take advantage of the large EC market. In the past few years, the Community has made considerable progress in formulating standards for selected industrial products with the result that a total of more than 100 directives have been issued by the Council which will eventually become binding on members of the Community.

A less obvious but quite important factor in promoting trade within the community is the tendency on the part of member governments to purchase, whenever possible, goods made within the community if they meet their specific needs. This has been especially true in the field of government-purchased telecommunications equipment, where manufacturers within the community have been favored over outside producers. Our Foreign Service posts carefully monitor this situation and provide direct support to American suppliers who may be adversely affected by it.

The European Community itself does not provide assistance to member nations in their export promotion activities. Each country is free to choose for itself the promotional activities it wishes. Nevertheless, the close trading links between member nations frequently make it possible for firms located in different member countries to join together in consortia to bid on overseas contracts. Antitrust policies in effect within the EC do not generally apply to trade with nations outside the community.

The trade creation impact of the common market has generally been advantageous to the U.S. As a whole, the community is the world's largest importer of U.S. products. In 1976, the nations of the EC imported over $27 billion from the U.S., (including agricultural products). Many American firms have found that by establishing production facilities within the EC, their competitiveness has been further enhanced. Repatriated earnings on these investments, plus the export from the U.S. to these firms of capital equipment, have been major sources of income and jobs for this country.

Developing Countries

For the most part developing countries do not now compete with U.S. exporters in overseas markets. The bulk of our exports are farm products, raw materials, aircraft, and sophisticated goods such as computers, chemicals and machinery. Developing countries, by contrast, export consumer products like apparel, shoes, small appliances and hand tools along with raw material and semi-finished goods. U.S. exporters rarely have complained that the developing countries are subsidizing exports of competing products to third country markets.

In 1975, manufactured goods constituted only 34% of total non-oil developing country exports. If textiles, shoes, and other consumer goods are subtracted from this figure, the remaining component of manufacturing exports of developing countries is only 20% of the total. While developing countries are, like the U.S., substantial food exporters, most of their food exports are tropical products compared to United States food exports of temperate crops like corn and wheat.

The subsidy practices of developing countries vary widely. Those developing countries, particularly the more advanced Asian and South American nations, which offer a variety of export subsidies, do so to attract capital, to make up for poorly developed infrastructures, to stimulate regional development and to permit local firms to survive until they reach economically viable production levels.

These countries often provide advantageous financing for exports and sometimes preferential financing for the establishment of export producing plants. The tax codes of a number of developing countries allow special tax credits, deductions, tax deferrals and depreciation for exporting companies. Developing countries seeking economic growth through trade frequently permit duty rebates for machinery and materials used in production for export. Some offer firms cash bounties based on export performance, or use multiple exchange rates to subsidize exports.

Brazil is one of a number of developing countries which employs export subsidies. On export transactions, it offers credits against taxes on industrial products and the circulation of goods. It likewise provides partial exemption from payment of the industrial products tax and import duties on machinery purchases dependent on export performance. It also gives tax relief on equipment and earnings to certain new industries and to industries in economically depressed areas. Finally, Brazil provides preferential financing for export transactions.

Though Brazil is a large, advanced developing country, its export subsidies do not now seem to pose a major problem for U.S. exporters, although there have of course been some countervailing duty cases in the U.S. market. Five primary commodities--coffee, sugar, iron ore, cocoa products and soybean products--comprise $5.7 billion, or 56%, of Brazil's 1976 exports of $10 billion. Brazil exported over $50 million in only three industrial categories--shoes ($100 million), motors ($62 million), and radios ($62 million).

Nevertheless, the problem of LDC subsidies affecting our exporters is likely to grow as developing countries progress and press their comparative advantage. The U.S. recognizes that most developing countries cannot at this time be expected to adhere strictly to the same trading rules that govern more industrialized nations. As developing countries advance, however, we expect them to accept the obligations of stronger economies and so to phase out subsidies and other trade distorting practices.

The Trading System and U.S. Exports

A key factor in expanding U.S. exports is an international trading system which is open and fair. The system established after World War II, based on the GATT, has resulted in a dramatic expansion in international trade. In order to further reap the benefits of liberal trade policies, the U.S. and other countries launched the "Tokyo Round" of trade negotiations in 1973. These

27-039 O - 78 - 6

are now moving toward an advanced state. A successful MTN, in which tariffs and other barriers to trade are reduced, will improve the competitive position of U.S. exports and likewise benefit other nations as well.

Other changes in the international trading system will also be beneficial. The answer to the exaggerated charge that the existing trading system is outmoded lies not in abandoning the system but in improving it. In the MTN we consequently seek not just a substantial reduction in tariffs but international agreements on a number of non-tariff measures, which are now at least as important as tariffs in restraining trade. These agreements would provide for greater international discipline and fairer procedures.

Of particular importance to the U.S., and particularly this Subcommittee, is agreement on a new code governing the use of subsidies and countervailing duties. Many countries use domestic subsidies, such as regional development aids and government aids to industry and agriculture, for legitimate national objectives other than trade. We hope to agree on a mechanism to deal with the damage that such subsidies may cause to the economic interests of other countries. We are also working to tighten existing agreements among the trading nations regarding export subsidies of non-primary goods, to update the 1960 illustrative list of prohibited practices, and to improve international discipline over these practices.

Agricultural subsidies are an especially difficult problem. Most major trading nations including ourselves maintain complex systems of agricultural subsidies and production and price controls. In this area we hope to reach agreement to limit the trade damage that results from the export of subsidized agricultural products.

Conclusions

The primary determinant of a nation's success in exporting is the existence of a substantial number of highly motivated and competitive domestic industries which are vigorously engaged in seeking out and exploiting sales opportunities in overseas markets. Of importance, too, are government policies that provide assistance to the export sector or, at the very least, do not impede the activities of private industry in its quest for overseas sales. All of this assumes a relatively free and open international market which is the *sine qua non* of a thriving export sector, which is why efforts to avoid import restrictions and to assure a successful Multilateral Trade Negotiations take on vital importance.

Government export promotion programs can help assure that information on foreign markets and firms is available to present and potential exporters; that opportunities are available to exporters to display their products abroad; and that exports are not unfairly discriminated against by foreign governments. But export promotion programs of this or any other country cannot be very effective in the absence of a commitment by the private sector itself to aggressively seek overseas markets.

This country is strengthening its efforts to improve the ability of its industry to export. As indicated, the Department of Commerce is actively and very effectively engaged in making industry more aware of the sales opportunities abroad and assisting it to take advantage of market opportunities. The State Department is strongly supporting Commerce with its network of foreign posts, knowledge of foreign makrets and officials, and considerable experience in this area.

We also regard the efforts of the Export-Import Bank to expand its export financing activities as a key element in the Administration's attempts to convince American firms to sell more abroad. The Eximbank is moving dynamically to provide necessary financing to help U.S. firms to move more rapidly into foreign markets.

Although much is now being done to improve our export performance, this Administration is searching for new and more effective ways to accomplish this important objective. I have already mentioned Commerce's export awareness program, the important efforts that are being made at Geneva to further reduce tariff and non-tariff barriers; the export promotion techniques that we have borrowed from our trading partners and other techniques that we might consider.

What more might be done? One could provide an almost endless list of ideas, and clearly improvement is possible and desirable. We welcome this subcommittee's views and recommendations. There is a good argument to be made that the present level and mix of U.S. government trade promotion efforts are about right in terms of what government-sponsored programs can be expected to accomplish. In the American tradition, these programs are designed mainly to facilitate and encourage private industry to take the lead itself in expanding its exports. But new approaches will be closely examined. In the final analysis, however, it is the private sector that must make the commitment and take the positive steps necessary to improve the export performance of this nation.

3/6/78

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Senator STEVENSON. Thank you. You indicated that the Japanese and I think some other countries don't spend a great deal to promote exports, but isn't that because they have trading companies, because they have production subsidies, and they are just more oriented to exports than we are, and because in general the relationship between industry and government is much more cooperative than it is in the United States, and they are supported in other ways, some of which Mr. Moore was mentioning a moment ago?

Mr. HORMATS. Yes. I think in the case of Japan, there is undoubtedly a greater degree of cooperation between industry and government. We have not seen evidence that subsidies are a problem. As a matter of fact, I have seen very little, if any, evidence that there are subsidies provided by the Government of Japan to Japanese exports.

There are, of course, arrangements whereby individual Japanese firms in preferred industries will be able to perhaps borrow more easily, not necessarily at subsidized rates, but just having better access to capital. I think the investment is made in primarily by the companies themselves in the export market. There is, as Mr. Moore has pointed out, a thriving export financing operation in a number of these countries. But I think when one looks at the fundamentals, the more determinative factor is that the companies themselves have invested vast amounts of resources. To be sure, export financing encourages them to do so, but it is not the determinative factor in most cases.

Senator STEVENSON. Isn't our export mix changing? If current trends are projected for say a decade, wouldn't we be acting like a LDC, exporting raw materials, food, and importing technology? Isn't that the direction in which we are presently headed? The manufactures, for example, are leveling off as a part of our exports.

Mr. HORMATS. I think it is clear that in a number of areas our import dependence on particular manufactured goods is, indeed, increasing. Textiles and shoes are more obvious cases, but steel, of course, is also one where we are increasing our dependence over a long period of time. It is not that sharp an increase, but over a period of 20 years, a larger share of our market is comprised of imports in some sectors.

But, on the other hand, we are moving up the so-called product ladder. And while we might import more goods of a more labor-intensive nature, more jobs in a properly growing economy will be created in higher technology, higher productivity areas.

I think the determinant of whether we are going to be able to adjust to growing imports in certain areas, is whether we have an economy which is growing at a rate rapid enough to create new investment and new jobs in more productive areas of the economy.

We are still, in the high technology areas, a major exporter. In chemical products, airplanes, and similar high technology goods and capital equipment, we are a major exporter. I think there is always a tendency to see us as going out of certain areas, with no other sectors to take up the slack. But I dont think that is the case in a dynamic economy.

Senator STEVENSON. Yesterday, Mr. Strauss is reported as saying that the decline of the dollar might delay a successful conclusion of the multilateral trade negotiations.

Has the depreciation of the dollar fueled protectionist sentiments and measures abroad, and export support abroad? Do you agree with what he said?

Mr. HORMATS. Well, I think there are two factors involved in this problem. One is the uncertainty created, a point you alluded to earlier in this hearing, by the volatility of the dollar. The dollar is the major reserve currency; most transactions in the world are in dollars. And, therefore, it is logical to assume that movements in the dollar create uncertainty. The movement of the dollar, though, vis-a-vis some currencies, is in a number of ways a rather logical thing. If you look at the U.S. deficit compared to the surpluses of other countries, it is logical to assume that the dollar would be moving in the opposite direction from the currencies of those countries.

I don't think, however, that the movement of the dollar has led to a new burst of export subsidies, or import restrictions.

There are concerns, of course, that the declining dollar will make American goods more competitive in the world, and consequently decrease the competitiveness of goods of other countries. But I have not seen any evidence of measures taken to retaliate against that prospect as of this point. In part I think it is because a number of people recognize that the movement of the dollar has probably overshot the market, and I think they expect at some point a recovery of the dollar. At least there is every reason to believe that will happen.

Senator STEVENSON. How do you and the State Department feel about the possibility of mixed credits that Chairman Moore and I were talking about a moment ago?

Mr. HORMATS. Well, I think that there are clearly some difficulties in providing mixed credits. A number of them were brought out by Chairman Moore. There has, however, been an intriguing idea circulated around, which is a softer window of the Export-Import Bank. You are probably familiar with that concept. It is a debated point within the executive branch.

My own feeling is that while I have not personally done any analysis as to how it would work, or how effective it might be, I think that there are a number of countries for which this sort of window would be somewhat attractive.

There are a number of developed countries, for instance that should and can take credits on hard terms, normal Exim terms. There are a number of other countries that can't take credits, except on very very soft terms—those provided by AID. There is a small category that fits somewhere in the middle, to whom this would be an attractive and appropriate type of financing.

The only problem is, of course, that it would require a subsidy, because the terms would be below the going rate of interest. I think one has to trade off the benefits in terms of perhaps increased exports to that middle group of countries, vis-a-vis the need to provide what coould be rather substantial subsidies to make up the differences between the lower rates of interest they would get and the market rate of interest.

So I honestly have not done enough work to give you an informed judgment. But I think we ought to look into that.

Senator STEVENSON. I was going to say, if you could, and soon, because we have to report Exim authorizing legislation, as you know, by the middle of May. If we could have the Department's thought on this proposition well before then, it would be helpful.

Mr. HORMATS. Yes, sir.

Senator STEVENSON. Have you read Humphrey-Hawkins?

Mr. HORMATS. I have read summaries of it, but I wouldn't pass myself as an expert.

Senator STEVENSON. Don't rely on the summaries. I can't recommend it for bedtime reading, but as a representative of the State Department, I commend it to your attention.

Mr. HORMATS. If I could make a point related to the remarks you made earlier, the remark about the bill's failure to focus on exports, which is extremely well taken. If you look at the increasing percentage of exports in the U.S. gross national product, exports have grown at a much more rapid rate than increases in the U.S. gross national product. And, looking at a bit of history, one of the major boons to American growth over the last several years has been the resurgence of the economies of Germany and Japan and some other countries in Western Europe. One has to look at the future in terms of the prospects of some of these middle-income countries, that are really the growth areas of the future. And I think that in trying to figure out a strategy, which is going to couple our efforts to increase growth at home with a strategy to increase growth abroad, the developing countries require particular attention in this area.

There was a good study done by the Joint Economic Committee, by Van Dorn Ormes, about a year or a year and a half ago, which related directly our ability to create jobs at home with the thriving export market and particularly in developing countries. This is certainly something that has to be factored in if we are looking at job creation in a broad sense.

Senator STEVENSON. I think the whole bill has its grosser aspects, but as a bill, the primary purpose of which is to create jobs, and which totally ignores the effect of exports on jobs, it is, to say the least, deficient in one respect. That may be just an oratory exercise by the Government that will come and go without any adverse consequences, except for the innocent people who are unemployed in the country, and who are being led to believe that it will create new job opportunities. That is my principal concern about that legislation, it is capable of working a deception on innocent and suffering people.

I guess we are going to have to stop, if this hearing is ever going to end. We may have some additional questions for you for the record. We would be grateful to you for answering them in writing.

Thank you very much.

Our next witness comprises a panel. They are: E. J. Frank, Parker-Hunter, Inc., Pittsburgh, Pa.: Richard Hammer, Special Committee on U.S. Exports, from Price Waterhouse & Co., New York; Thomas Hammer, assistant director for national affairs, American Farm Bureau; and Peter McCloskey, president, Electronic Industries Association.

Gentlemen, I thank you for your patience, and I will invite you, as I have the others, to summarize your statements if you will. I have to leave here by 1 to be on the Senate floor. Shall we start with you, Mr. Frank?

STATEMENT OF E. J. FRANK, VICE PRESIDENT, PARKER/HUNTER, INC., PITTSBURGH, PA.

Mr. FRANK. I am going to find it rather difficult to brief my statement. I didn't know this was the structure. I think what I have to say will take only about 12 or 13 minutes.

Senator STEVENSON. Let's make it a short 12 minutes, if you can.

Mr. FRANK. So many of the points that were mentioned this morning I think I have contained in the statement. And one of the first points was about the economists from our Western World who are interested in international trade, monetary and fiscal policy, unemployment, welfare and energy problems, have a great deal to learn from Japan, but they have very seldom undertaken serious study of what is really happening there.

Most of the work that has been done on the Japanese uses our Western concepts of rationale, and completely misses the target when we come up with our estimates and answers.

The Japanese like to say that theirs is an unplanned free enterprise economy, but in our Western terms, it is not. It is consciously designed system of a different order. The ultimate responsibility for industrial planning, for deciding in which direction Japan's industrial efforts should go, and for fostering and protecting business as it moves in those directions, lies with the Government. Business, banking, and the Government are all on the same team and broadly function as a partnership to implement the policies and plans of the Government.

Government agencies, such as the Ministry of Finance, the E.P.A., and M.I.T.I., which design and administer Japanese economic policy, are staffed by some of the most brilliant young men in Japan, and this is one of the reasons why "administrative guidance" in Japan works. The brightest graduates from Japan's universities throng to get into the civil service for a good reason: It is the golden road to the top, not only in the civil service itself, but in banking, industry, and politics as well. Today's top men in major companies, banks, and business houses were civil servants not too many years ago.

Group loyalty is a deeply ingrained Japanese characteristic. An employee's main duty is to the interests of his group or company, and he always remembers that behind that lies the interests of the greater company of Japan. Japan's economic policy has been and is still expansionary. Investment in the capital sector of the economy has been at levels approximately 30 percent of the GNP compared to 9 percent in the United States. Included in the expansionary philosophy is the concept of full lifetime employment which offsets the need for elaborate welfare and unemployment compensation programs. In their system, unemployment is exported.

The job of government is to use every resource of fiscal policy, monetary policy, and administrative planning to insure that high levels of investment are continually maintained.

I have in the written text shown how this high investment which is termed "forced draught investment," is initiated and carried out. We can reflect on that later.

The main part the Government plays in maintaining a balance between expansion of capacity and increasing productivity is their push toward automation. If Japan has any advantage internationally, aside from their system itself, it is Japan's cost of labor, which is by design kept low. How they operate their Government and do things, like manage their balance of payments, I will skip and get to the point you were on earlier this morning.

Prior to World War II banking and business was carried on by controlling groups called the Zaibatsu. During this period there were three or so major groups: Mitsuibishi, Mitsui, and Sumitomo, and perhaps also Yasuda. Today, the number of these groups has expanded considerably, with perhaps 25 to 30 large bank-dominated groups and multitudes of smaller ones.

These bank-led groups are difficult to comprehend, since no other nation in the world has this form of organization. Each group consists of banking interests, trading houses, and a multiplicity of industrial concerns representing a variety of products.

The banks do the financing, the trading houses do the purchasing, marketing, carrying of inventory, market research and on, while the industrial concerns produce the products. In turn, the unit is supported and controlled by the Bank of Japan and a variety of Government agencies.

Japan's continuing investment boom is financed by the Bank of Japan, which controls the creation of money by the commercial banking system, and the commercial banks then provide the necessary credit to the trading houses and industrial concerns in their groups.

The Japanese are offering American business 180-day terms, or products on consignment. In the terms of steel, this means a discount of $18 to $20 a ton. The steel industry, I think, is one of the best examples to illustrate how the Japanese system works.

Right after World War II Japanese planners chose steel as a target industry. Other industries chosen, but with slightly less emphasis, were coal, electricity, and shipping. Today, there are a great many others, such as autos, petrochemicals, but steel continues to be considered the "rice" industry.

The metal, steel, is regarded by the Japanese as the most critical material for industrial development. Without a reliable domestic supply of steel, they believe as a nation they cannot economically manufacture the necessary key capital goods and develop strong components in other areas of the economy. Steel exports, both direct and indirect, have been Japan's most important source of foreign exchange.

One of the prerequisites of building a strong domestic steel industry has been to maintain a protected home market. This has been easy for the Japanese to accomplish because of these nature of the Japanese marketing system, which effectively precludes the entry of foreign products not required for a particular purpose.

As a target industry, the Japanese Government eliminated the conventional problem of capital formation which at best is a slow process in the United States. The Japanese steel industry enjoys virtually unlimited capital availability which permitted it to expand from less than 1 million net tons of steel production in 1946 to approximately 153 million net tons of raw steel capacity at the end of 1977. To support this growth, the Japanese steel industry has relied heavily on leverage and has a debt-to-total capital ratio approximating 85 percent. This compares with the current U.S. industry average of approximately 28 percent.

The Japanese have access to the money markets in other countries even at times when the domestic industry in that country finds it difficult to borrow.

As an example, in 1977 a major domestic steel company in the top 10 found it impossible to borrow funds. This was due to the fact that its debt-to-equity ratio was on the high side of the U.S. industry average at 38 percent. The company's net profit margin was a meager 1 percent based on its 1976 annual report.

During this same period, a Japanese steel company, one of the big five, encountered no difficulty in borrowing funds in the United States. This was accomplished despite the fact that the Japanese steel company had a debt-to-equity ratio of approximately 90 percent, and its net profit margin approximately 7 percent. The difference in results was due to the fact that the Japanese company's lead commercial bank guaranteed the loan. The commercial bank, in turn, is supported by the Bank of Japan.

As of March 31, 1977, a variety of Japanese companies had borrowed $1,216,400,000 from major U.S. banks. Nippon Steel alone borrowed $288,100,000 in the United States, or 5.8 percent of its total debt. It borrowed another 5 percent of its total debt in Europe, all guaranteed by the Japanese banking system, a luxury U.S. companies do not enjoy.

A large major trading company in Japan with current sales approximating $35 billion can play a most unique role which provides all Japanese industry with an advantage in international trade that cannot be matched by its trading partners, particularly the United States.

As an example, during 1974 steel consumers around the world were willing to pay as much as $600 per ton for steelplate produced by the steel company in the trading companies group. The steel company, during this period of prosperity, had a net profit margin of 1½ percent and the trading company had a net profit margin of 1.7 percent.

In the following year, 1975, the same trading company offered steelplate at prices below $200 per ton. The 1975 profit margin of the steel company remained at 1½ percent and the trading company 1.7 percent.

Huge profits were made in 1974, but were not reflected in any of the profit-and-loss statements. The steel company, over and above its modest profit, received a tax-free credit on the books of the trading company to be used at some future date. Some of the profit on steel was also used by the trading company to offset losses in other areas. In 1974 this same trading company was selling textiles provided by a company in its group at 30 cents on the dollar, and was discounting steel to the automotive company in the group to make them more competitive. During 1975 when steel prices were down, the steel company was able to sell product below cost. The obvious operating loss could be offset by a withdrawal from the reserves built up in the prior year. The ability to sell steel at any price stabilizes volume, thus enabling the steel company to maintain full employment. In this case, the unemployment was exported to the United States.

The trading companies are sales-oriented and through the years developed ways to generate indirect volume for its steel industry internationally. Of particular interest is the area of fabrication which includes bridges and fasteners to name a few.

The Japanese are pursuing bridge fabrication markets in the United States. The overall capability of their system makes it impossible for U.S. firms to compete. An an example, the Japanese were just awarded a contract, with a bid of $41,800,000 to fabricate a bridge in Luling, La.

The lowest U.S. bid of $62,933,000 was entered by the American Bridge Division of U.S. Steel. Analysis would reveal that the Japanese bid barely covers the cost of material. Continuation of this practice will force many American fabricators out of business.

In the past 12 months the Japanese have taken well over 30 percent of the bridge market in the United States. It is estimated that in 1978 it will run between 50 to 60 percent of the market. Ironically, during the boom of 1974, when U.S. bridge fabricators enjoyed an unprecedented volume of orders, job completion was delayed due to shortages. Although the steel market was tight, steel was available usually at a high foreign price, but we couldn't get domestic, because we didn't have the capability, but fasteners were impossible to get. The U.S. capability to produce fasteners had been eroded in earlier years as a result of unfair pricing policies of our foreign suppliers. Currently foreign imports account for over 50 percent of our source of supply. U.S. fastener companies are continuing to drop out of business, I believe so far four in 1978, making the United States yet more dependent upon unreliable foreign sources of supply.

This is an excellent example of a foreign producer buying a major portion of an American market. It also lends credibility to the argument that the loss of such productive capability poses a great threat to our national security.

Energy prices have created problems for industrial nations around the world. The Japanese have devised programs and ways to partially take advantage of a bad situation. The steel industry is a major beneficiary of the Japanese energy requirements for which its pay cartel prices approximately $14 a barrel. According to a recent study by I.V.M. Inc., who worked on the Gilmore dumping case for over two years, and have great detail on it, they state that in the Japanese system the steel industry is only charged $6 to $7 per barrel. This allows the steel industry a cost advantage with which it can generate export volume which contributes to Japan's favorable balance of trade which enables it to cover the costs of its energy requirements.

The same may be said for electrical power. The Japanese steel industry is the recipient of a huge discount from true power costs in Japan. The cost of producing electrical power in Japan, using Mid East oil, is three to four times that of U.S. utilities using coal in the steel-producing areas. Yet the Japanese steel industries power costs are equal to or lower than its United States counterpart. This clearly demonstrates the favor position given to the Japanese steel industry by its government.

I just completed a study on a malting company that eventually goes to beer. All beer is is energy, barley and water. They can buy the barley in the United States, buy the oil in the Middle East, use their own water, subsidize the energy in Japan, and beer is coming in on the West Coast below American costs. That is another use of the energy program.

The U.S. reference pricing system, which is based on Japanese costs of production, does not recognize the aforementioned export aids. Nor does it consider any of the other advantages provided by the Japanese system itself.

The Japanese system itself, that includes the trading companies playing all sorts of games, discounting and so on, to compound the problem, other nations, including developing nations, understand the Japanese concepts and are beginning to emulate them in world trade.

By design, the Japanese are well on the way to dominating the world steel industry by 1985.

In the process, our domestic steel industry fabricating industries are slowly being destroyed as evidenced by massive layoffs and plant closings despite our cost competitiveness. I think there were 70,000 unemployed steel workers in 1977.

So far the U.S. Government has documented and has turned over $100 million in payments in this area. The unions themselves said the $100 million would have been much better spent in new plant and equipment.

Unless the U.S. Government acts in response to this challenge, and offers counter actions to insure the stability and growth of its own basic industrial capabilities, our Nation's future competitiveness in domestic as well as world markets will continue to deteriorate.

[The complete statement of Mr. Frank follows:]

STATEMENT

OF

E. J. FRANK

VICE PRESIDENT, PARKER/HUNTER, INC.

JAPANESE GOVERNMENT AND BUSINESS

AN OVERVIEW

JAPAN'S REMARKABLE SYSTEM OF ECONOMIC PLANNING AND SOCIAL ORGANIZATION HAS ACHIEVED WHAT HAS PROBABLY BEEN THE MOST SUCCESSFUL RAPID ECONOMIC GROWTH STORY OF ALL TIME.

ECONOMISTS FROM OUR WESTERN WORLD WHO ARE INTERESTED IN INTERNATIONAL TRADE, MONETARY AND FISCAL POLICY, UNEMPLOYMENT, WELFARE AND ENERGY PROBLEMS HAVE A GREAT DEAL TO LEARN FROM JAPAN, BUT THEY HAVE VERY SELDOM UNDERTAKEN SERIOUS STUDY OF WHAT IS REALLY HAPPENING THERE.

MOST OF THE WORK THAT HAS BEEN DONE IN THESE AREAS HAS UTILIZED WESTERN CONCEPTS AND RATIONAL IN ECONOMIC RESEARCH AND AS A RESULT HAS MISUNDERSTOOD THE JAPANESE CONCEPT OF BUSINESS.

THE JAPENESE LIKE TO SAY THAT THEIRS IS AN UNPLANNED, FREE ENTERPRISE ECONOMY. BUT, IN WESTERN TERMS: IT IS NOT. IT IS A CONSCIOUSLY DESIGNED SYSTEM OF A DIFFERENT ORDER. THE ULTIMATE RESPONSIBILITY FOR INDUSTRIAL PLANNING, FOR DECIDING IN WHICH DIRECTIONS JAPAN'S INDUSTRIAL EFFORTS SHOULD GO, AND FOR FOSTERING AND PROTECTING BUSINESS AS IT MOVES IN THOSE DIRECTIONS, LIES WITH THE GOVERNMENT. BUSINESS, BANKING, AND THE GOVERNMENT ARE ALL ON THE SAME TEAM AND BROADLY FUNCTION AS A PARTNERSHIP TO IMPLEMENT THE POLICIES AND PLANS OF THE GOVERNMENT.

GOVERNMENT AGENCIES SUCH AS THE MINISTRY OF FINANCE, THE E.P.A. & M.I.T.I. WHICH DESIGN AND ADMINISTER JAPANESE ECONOMIC POLICY, ARE STAFFED BY SOME OF THE MOST BRILLIANT YOUNG MEN IN JAPAN AND THIS IS ONE OF THE REASONS WHY "ADMINISTRATIVE GUIDANCE" IN JAPAN WORKS. THE BRIGHTEST GRADUATES FROM JAPAN'S UNIVERSITIES

THRONG TO GET INTO THE CIVIL SERVICE AND FOR A GOOD REASON: IT IS THE GOLDEN ROAD TO THE TOP NOT ONLY IN THE CIVIL SERVICE ITSELF BUT IN BANKING, INDUSTRY, AND POLITICS AS WELL. TODAY'S TOP MEN IN MAJOR COMPANIES, BANKS AND BUSINESS HOUSES WERE CIVIL SERVANTS NOT TOO MANY YEARS AGO.

GROUP LOYALTY IS A DEEPLY INGRAINED JAPANESE CHARACTERISTIC. AN EMPLOYEE'S MAIN DUTY IS TO THE INTERESTS OF HIS GROUP OR COMPANY AND HE ALWAYS REMEMBERS THAT BEHIND THAT LIES THE INTERESTS OF THE "GREATER COMPANY" OF JAPAN. JAPAN'S ECONOMIC POLICY HAS BEEN AND IS STILL EXPANSIONARY. INVESTMENT IN THE CAPITAL SECTOR OF THE ECONOMY HAS BEEN AT LEVELS APPROXIMATING 30% OF GNP COMPARED TO 9% IN THE U. S. A. INCLUDED IN THE EXPANSIONARY PHILOSOPHY IS THE CONCEPT OF FULL LIFE TIME EMPLOYMENT WHICH OFFSETS THE NEED FOR ELABORATE WELFARE AND UNEMPLOYMENT COMPENSATION PROGRAMS. IN THEIR SYSTEM, UNEMPLOYMENT IS EXPORTED.

THE JOB OF GOVERNMENT IS TO USE EVERY RESOURCE OF FISCAL POLICY, MONETARY POLICY, AND ADMINISTRATIVE PLANNING TO INSURE THAT HIGH LEVELS OF INVESTMENT ARE CONTINUALLY MAINTAINED.

MOST OF JAPAN'S HIGH RATE OF INVESTMENT MAY BEST BE TERMED "FORCED DRAUGHT INVESTMENT". IT IS INITIATED BY GOVERNMENT POLICY AND CARRIED OUT BY UNIQUE INDUSTRIAL GROUPINGS DOMINATED BY BANKS WHICH I WILL DISCUSS PRESENTLY.

WESTERN ECONOMISTS AND BANKERS HAVE LONG BEEN PUZZLED AS TO HOW "FORCED DRAUGHT INVESTMENT" AT SUCH EXTRAORDINARY HIGH LEVELS CAN BE ACCOMPLISHED WITHOUT GENERATING MASSIVE INFLATION. THERE ARE SEVERAL WHICH ENTER INTO THE ANSWER:

A. DEFENSE EXPENDITURES TAKE APPROXIMATELY ONLY 1% OF NATIONAL INCOME.

B. CONSUMPTION AS A PROPORTION OF PERSONAL INCOME IS ABOUT 10% LOWER THAN IN OTHER INDUSTRIALIZED NATIONS.

C. CORRESPONDINGLY PERSONAL SAVINGS ARE AT A MUCH HIGHER RATE. THIS IS POSSIBLE PARTLY BECAUSE WORKERS RECEIVE A SEMI-ANNUAL BONUS WHICH MAY EQUAL AS MUCH AS 42% OF

REGULAR EARNINGS. ALSO SINCE WORKERS DO NOT RECEIVE PENSIONS, MERELY A LUMP SUM PAYMENT EQUIVALENT TO ONE YEAR'S SALARY ON RETIREMENT, THE NEED FOR PERSONAL SAVINGS IS PRESSING.

ANOTHER QUESTION FREQUENTLY ASKED BY WESTERN ECONOMIST IS HOW SUCH HIGH RATES OF ECONOMIC GROWTH CAN BE SUSTAINED WITHOUT CREATING PRODUCTION BOTTLENECKS AND ENCOUNTERING LIMITATIONS ON REAL RESOURCES.

THE MAIN PART OF THE ANSWER LIES IN THE FACT THAT AS EXPENDITURES ARE INCREASED REAL RESOURSES, ESPECIALLY LABOR RESOURCES, ARE CONSTANTLY REDIRECTED TO MORE EFFICIENT USES. IN JAPAN, THE NEED TO KEEP THE WORK FORCE FULLY EMPLOYED IS IMPERATIVE; CONSEQUENTALLY, THERE IS A CONTINUOUS FLOW OF LABOR FROM AREAS OF LOW PRODUCTIVITY TO AREAS OF HIGH PRODUCTIVITY, FOR EXAMPLE, FROM UMBRELLA MANUFACTURING TO AUTOMOBILES AND STEEL.

GOVERNMENT DIRECTION PLAYS A KEY ROLE IN THIS PROCESS, MAINTAINING A CONTINUOUS BALANCE BETWEEN THE EXPANSION OF CAPACITY AND THE INCREASE IN PRODUCTIVITY---IN OTHER WORDS, THE DEGREE OF "AUTOMATION" IS VERY HIGH. IF JAPAN HAS ANY ADVANTAGE INTERNATIONALLY, ASIDE FROM THEIR SYSTEM ITSELF, IT IS IN JAPAN'S LOW COST OF LABOR, WHICH IS BY DESIGN KEPT LOW.

A PARTICULARLY SIGNIFICANT ITEM IS THE MANNER IN WHICH THE JAPANESE MANAGE THEIR BALANCE OF PAYMENTS. THE GOVERNMENT NOT ONLY FOLLOWS A POLICY OF PUSHING EXPORTS STRONGLY BUT IT ALSO MAINTAINS THROUGH THE M.I.T.I. WHAT IS EFFECTIVELY A "NO IMPORT" POLICY EXCEPT FOR THOSE ITEMS WHICH CANNOT BE OBTAINED OR PRODUCED AT HOME. THERE IS NO FORMAL "BUY JAPANESE" POLICY BUT INFORMALLY CONTROL IS SO RIGOROUS THAT IT IS IMPOSSIBLE TO GET FOREIGN PRODUCTS INTO JAPAN UNLESS THEY ARE VIRTUALLY NEEDED AND HAVE M.I.T.I. APPROVAL. THIS INFORMAL M.I.T.I. CONTROL IS EXERCISED THROUGH THE COMPLICATED STRUCTURE OF THE JAPANESE MARKETING SYSTEM ITSELF. IF THE PRODUCT IS UNDESIRED BY THE GOVERNMENT, IT IS IMPOSSIBLE TO GET IT MARKETED THROUGH THE TRADING HOUSE SYSTEM, NOT TO MENTION THE IMPOSSIBILITY

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OF OBTAINING THE CREDIT TO DO SO.

THE BANK OF JAPAN EXERCISES STRICT CURRENCY CONTROL. ALL FOREIGN CURRENCY GENERATED FROM EXPORT EARNINGS MUST BE CONVERTED TO LOCAL CURRENCY WITHIN 10 DAYS. THE CENTRAL BANK, AT TIMES, IS ABLE TO MANIPULATE THE VALUES OF KEY FOREIGN CURRENCIES. THE BANKS OF JAPAN WORKS IN CLOSE CONCERT WITH INDUSTRY AND COMMERCIAL BANKING SYSTEM.

PRIOR TO WORLD WAR II BANKING AND BUSINESS WAS CARRIED ON BY CONTROLLING GROUPS CALLED THE ZAIBATSU. DURING THIS PERIOD THERE WERE THREE OR SO MAJOR GROUPS: MITSUBISHI, MITSUI AND SUMITOMO, AND PERHAPS ALSO YASUDA. TODAY THE NUMBER OF THESE GROUPS HAS EXPANDED CONSIDERABLY, WITH PERHAPS 25-30 LARGE BANK DOMINATED GROUPS AND MULTITUDE OF SMALLER ONES.

THESE BANK-LED GROUPS ARE DIFFICULT TO COMPREHEND, SINCE NO OTHER NATION IN THE WORLD HAS THIS FORM OF ORGANIZATION. EACH GROUP CONSISTS OF BANKING INTERESTS, TRADING HOUSES AND A MULTIPLICITY OF INDUSTRIAL CONCERNS REPRESENTING A VARIETY OF PRODUCTS.

THE BANKS DO THE FINANCING, THE TRADING HOUSES DO THE PURCHASING, MARKETING, CARRYING OF INVENTORY, MARKET RESEARCH, ETC. WHILE THE INDUSTRIAL CONCERNS PRODUCE THE PRODUCTS. IN TURN THE UNIT IS SUPPORTED AND CONTROLLED BY THE BANK OF JAPAN AND A VARIETY OF GOVERNMENT AGENCIES.

JAPAN'S CONTINUING INVESTMENT BOOM IS FINANCED BY THE BANK OF JAPAN WHICH CONTROLS THE CREATION OF MONEY BY THE COMMERCIAL BANKING SYSTEM; AND THE COMMERCIAL BANKS THEN PROVIDE THE NECESSARY CREDIT TO THE TRADING HOUSES AND INDUSTRIAL CONCERNS IN THEIR GROUPS.

FOR EXAMPLE, A JAPANESE STEEL FIRM OBTAINS OVER 90% OF ITS FINANCING FROM BANK LOANS. THE REMAINING 10%---THE EQUITY PORTION---MAY ALSO BE SUPPLIED IN PART BY THE BANKS AND IN PART BY OTHER MEMBERS OF THE GROUP SUCH AS THE TRADING HOUSES. THE REMAINDER IS OWNED BY THE PUBLIC.

THE LIFE BLOOD OF THE JAPANESE ECONOMY IS A FLOW OF MUTUAL TRADING CREDITS

ALL CONTROLLED AT THE SOURCE BY THE BANK OF JAPAN.

IN JAPAN, LARGE FIRMS ARE FAVORED BY THE GOVERNMENT AND THEY CAN COUNT ON THE BANKS FOR FINANCING. THE SMALL FIRMS LEAD A MORE PRECARIOUS EXISTANCE AND ARE NEVER QUITE CERTAIN WHETHER CREDITS ARE RENEWED OR NOT.

A MANUFACTURING FIRM SELLS ITS PRODUCT TO A TRADING HOUSE IN ITS GROUP AGAINST THREE MONTH BILLS WHICH IT CAN IMMEDIATELY DISCOUNT. THE TRADING HOUSE SIMILARLY UTILIZES SUCH BILLS TO FINANCE SALES TO OTHER WHOLESALERS AND SUB-WHOLESALERS ONLY THE FINAL CONSUMERS PAY CASH. WHEN A MANUFACTURER BUYS MATERIALS FROM ITS RELATED TRADING HOUSE, THE TRADING HOUSE PAYS FOR THE DOMESTIC PORTION OF MATERIALS WITH STRETCHED OUT IOU'S, AND OTHERS DOWN THE LINE STRETCH THEIRS OUT STILL FURTHER.

DUE TO THE FACT THAT THE JAPANESE ECONOMY IS RUN SO LARGELY ON IOU'S IN ORDER TO SUPPORT ITS ECONOMIC GROWTH AND FULL EMPLOYMENT POLICIES, THE COUNTRY IS IN A PERMANENT "TIGHT MONEY SITUATION." ACCORDING TO THE BANK OF JAPAN THE NATIONS BANKS HAVE CHRONICALLY BEEN IN AN OVER-LOANED CONDITION. CITY BANKS HAVE UTILIZED THEIR CREDIT CREATION FUNCTION TO THE EXTREME IN ORDER TO MEET THE CREDIT DEMANDS OF THEIR CLIENT ENTERPRISES. THE SHORTAGE OF CASH RESERVES HAS BEEN CONSTANTLY FILLED WITH MASSIVE BORROWINGS FROM THE BANK OF JAPAN.

WHEN FINANCIAL TROUBLE THREATENS, AS IT DID DURING THE RECESSIONARY PERIOD, 1975 AND 1976, A SHARP AND SUDDEN CREDIT SQUEEZE BY THE BANK OF JAPAN GENERALLY SENDS JAPANESE EXPORTS SOARING.

WHEN DOMESTIC DEMAND SAGS, THE GOVERNMENT MOVES TO OFFSET THE DECLINE. IT DOES THIS BY STEPPING UP EXPENDITURES FOR SOCIAL PROJECTS, ENCOURAGING CAPITAL EXPENDITURES, AND PUSHING EXPORTS WHILE HOLDING DOWN IMPORTS. EXPORT GAIN, AT ANY MARKET PRICE, ENABLE THE GOVERNMENT TO <u>MAINTAIN FULL EMPLOYMENT</u>. LOSSES, IF ANY FROM THIS EXPORT PRACTICE, ARE ULTIMATELY ABSORBED BY THE BANK OF JAPAN.

WHEN A SQUEEZE OCCURS, "PAPER GETS LONGER", THE IOU'S WITH WHICH MOST DOMESTIC PRUCHASES ARE FINANCED MAY SWELL FROM A NORMAL 90 DAYS TO <u>"PREGNANCY</u>

NOTES" OF 9 OR 10 MONTHS OR LONGER. MOREOVER, AT SUCH TIMES, THE MARKET OR DISCOUNT RATE ON SUCH "PREGNANCY" PAPER MAY SOAR TO 15 OR 20% OR MORE. TODAY THERE IS EVIDENCE THAT SOME PAPER HAS BEEN EXTENDED WELL OVER 2 YEARS. AS AN EXAMPLE, JAPANESE SERVICE CENTER RECEIVABLES, WHEN AGED, ARE NOW OVER 750 DAYS OLD. IN THESE CIRCUMSTANCES, AN EXPORT DELIVERY, WHICH WILL BE PAID FOR FAR MORE QUICKLY ON A SIGHT BILL, BECOMES A MUCH MORE DESIRABLE DELIVERY TO MAKE FOR A COUNTRY DESPERATE FOR MONEY.

ALL ARGUMENTS ABOUT WHETHER JAPANESE FIRMS "DUMP" EXPORTS IN SUCH CONDITIONS BECOMES QUITE MEANINGLESS WHEN THE FACTORS OF QUICKER PAYMENT AND FULL EMPLOYMENT ARE UNDERSTOOD. "DUMPED" EXPORTS AT "SQUEEZE TIME" ARE MORE PROFITABLE THAN HOME MARKET SALES EVEN IF EXPORT PRICES ARE BELOW COST. AN "EXPORT PUSH CAPABILITY," IN THE FORM OF TRADING HOUSES, IS ALWAYS ON STANDBY READY TO OFFSET DOMESTIC FINANCIAL SQUEEZES. THE JOB OF THESE TRADING HOUSES IS TO KNOW WHERE TO PLACE PRODUCTS TO KEEP THE MILLS AND PEOPLE AT HOME WORKING.

IN THE SQUEEZE YEAR OF 1965, JAPAN'S EXPORTS ROSE 26.7%, NICELY OFFSETTING THE DROP IN JAPANESE DOMESTIC MARKETS AND PRODUCING A FAVORABLE BALANCE OF TRADE. OTHER SQUEEZE PERIODS HAVE BEEN HANDLED THE SAME WAY, AND WHAT HAS BEEN TRUE IN THE PAST, IS AGAIN PROVING TRUE TODAY WITH A VENGENCE.

THE STEEL INDUSTRY IS ONE OF THE BEST EXAMPLES TO ILLUSTRATE HOW THE JAPANESE SYSTEM WORKS.

RIGHT AFTER WORLD WAR II JAPANESE PLANNERS CHOSE STEEL AS A "TARGET INDUSTRY." OTHER INDUSTRIES CHOSE, BUT WITH SLIGHTLY LESS EMPHASIS, WERE COAL, ELECTRICITY, AND SHIPPING. TODAY THERE ARE A GREAT MANY OTHERS SUCH AS AUTOS AND PETRO CHEMICALS, BUT STEEL CONTINUES TO BE CONSIDERED THE "RICE" INDUSTRY.

THE METAL, STEEL, IS REGARDED BY THE JAPANESE AS THE MOST CRITICAL MATERIAL FOR INDUSTRIAL DEVELOPMENT. WITHOUT A RELIABLE DOMESTIC SUPPLY OF STEEL, THEY BELIEVE AS A NATION THEY CAN NOT ECONOMICALLY MANUFACTURE THE NECESSARY KEY

CAPITAL GOODS AND DEVELOP STRONG COMPONENTS IN OTHER AREAS OF THE ECONOMY. STEEL EXPORTS, BOTH DIRECT AND INDIRECT, HAVE BEEN JAPAN'S MOST IMPORTANT SOURCE OF FOREIGN EXCHANGE.

ONE OF THE PREREQUESTS OF BUILDING A STRONG DOMESTIC STEEL INDUSTRY HAS BEEN TO MAINTAIN A PROTECTED HOME MARKET. THIS HAS BEEN EASY FOR THE JAPANESE TO ACCOMPLISH BECAUSE OF THE NATURE OF THE JAPANESE MARKETING SYSTEM WHICH EFFECTUALLY PRECLUDES THE ENTRY OF FOREIGN PRODUCTS NOT REGUIRED FOR A PARTICULAR PURPOSE.

AS A "TARGET" INDUSTRY THE JAPANESE GOVERNMENT ELIMINATED THE CONVENTIONAL PROBLEM OF CAPITAL FORMATION WHICH AT BEST IS A SLOW PROCESS IN THE U. S. THE JAPANESE STEEL INDUSTRY ENJOYS VIRTUALLY UNLIMITED CAPITAL AVAILABILITY WHICH PERMITTED IT TO EXPAND FROM LESS THAN ONE MILLION NET TONS OF STEEL PRODUCTION IN 1946 TO APPROXIMATELY 153 MILLION NET TONS OF RAW STEEL CAPABILITY AT THE END OF 1977. TO SUPPORT THIS GROWTH, THE JAPANESE STEEL INDUSTRY HAS RELIED HEAVILY ON LEVERAGE AND HAS A DEBT-TO-TOTAL CAPITAL RATIO APPROXIMATING 85%. THIS COMPARES WITH THE CURRENT U. S. INDUSTRY AVERAGE OF APPROXIMATELY 28%.

THE JAPANESE HAVE ACCESS TO THE MONEY MARKETS IN OTHER COUNTRIES EVEN AT TIMES WHEN THE DOMESTIC INDUSTRY IN THAT COUNTRY FINDS IT DIFFICULT TO BORROW. AS AN EXAMPLE:

IN 1977 A MAJOR DOMESTIC STEEL COMPANY IN THE TOP 10 FOUND IT IMPOSSIBLE TO BORROW FUNDS. THIS WAS DUE TO THE FACT THAT ITS DEBT TO EQUITY RATIO WAS ON THE HIGH SIDE OF THE U. S. INDUSTRY AVERAGE AT 38%. THE COMPANY'S NET PROFIT MARGIN WAS A MEAGER 1% BASED ON ITS 1976 ANNUAL REPORT.

DURING THIS SAME PERIOD, A JAPANESE STEEL COMPANY, ONE OF THE BIG FIVE, ENCOUNTERED NO DIFFICULTY IN BORROWING FUNDS IN THE U. S. THIS WAS ACCOMPLISHED DISPITE THE FACT THAT THE JAPANESE STEEL COMPANY HAD A DEBT TO EQUITY RATIO OF APPROXIMATELY 90% AND ITS NET PROFIT MARGIN APPROXIMATED 1%. THE DIFFERENCE IN RESULTS WAS DUE TO THE FACT THAT THE JAPANESE COMPANY'S LEAD COMMERCIAL BANK

GUARANTEED THE LOAN. THE COMMERCIAL BANK IN TURN IS SUPPORTED BY THE BANK OF JAPAN.

AS OF 3/31/77, A VARIETY OF JAPANESE COMPANIES HAD BORROWED $1,216,400,000 FROM MAJOR BANKS IN THE U. S. NIPPON STEEL ALONE BORROWED $288,100,000 IN THE U. S. OR 5.8% OF ITS TOTAL DEBT. IT BORROWED ANOTHER 5% OF ITS TOTAL DEBT IN EUROPE---ALL GUARANTEED BY THE JAPANESE BANKING SYSTEM. A LUXURY U. S. COMPANIES DO NOT ENJOY.

A LARGE MAJOR TRADING COMPANY IN JAPAN WITH CURRENT SALES APPROXIMATING $35 BILLION CAN PLAY A MOST UNIQUE ROLE WHICH PROVIDES ALL JAPANESE INDUSTRY WITH AN ADVANTAGE IN INTERNATIONAL TRADE THAT CANNOT BE MATCHED BY ITS TRADING PARTNER--PARTICULARLY THE U. S. A.

AS AN EXAMPLE, DURING 1974, STEEL CONSUMERS AROUND THE WORLD WERE WILLING TO PAY AS MUCH AS $600 PER TON FOR STEEL PLATE PRODUCED BY THE STEEL COMPANY IN THE TRADING COMPANIES GROUP. THE STEEL COMPANY, DURING THIS PERIOD OF PROSPERITY, HAD A NET PROFIT MARGIN OF 1 1/2% AND THE TRADING COMPANY HAD A NET PROFIT MARGIN OF 1.7%.

THE FOLLOWING YEAR, 1975, THE SAME TRADING COMPANY OFFERED STEEL PLATE AT PRICES BELOW $200 PER TON. THE 1975 PROFIT MARGIN OF THE STEEL COMPANY REMAINED AT 1 1/2% AND THE TRADING COMPANY 1.7%.

HUGE PROFITS WERE MADE IN 1974 BUT WERE NOT REFLECTED IN ANY OF THE P & L'S. THE STEEL COMPANY OVER AND ABOVE ITS MODEST PROFIT RECEIVED A TAX-FREE CREDIT ON THE BOOKS OF THE TRADING COMPANY TO BE USED AT SOME FUTURE DATE. SOME OF THE PROFIT ON STEEL WAS ALSO USED BY THE TRADING COMPANY TO OFFSET LOSSES IN OTHER AREAS. IN 1974 THIS SAME TRADING COMPANY WAS SELLING TEXTILES PROVIDED BY A COMPANY IN ITS GROUP AT 30 CENTS ON THE DOLLAR AND WAS DISCOUNTING STEEL TO THE AUTOMOTIVE COMPANY IN THE GROUP TO MAKE THEM MORE COMPETITIVE. DURING 1975 WHEN STEEL PRICES WERE DOWN, THE STEEL COMPANY WAS ABLE TO SELL PRODUCT BELOW COST. THE OBVIOUS OPERATING LOSS COULD BE OFFSET BY A WITHDRAWAL FROM THE RESERVES

BUILT UP IN THE PRIOR YEAR. THE ABILITY TO SELL STEEL AT ANY PRICE STABILIZE VOLUME; THUS, ENABLING THE STEEL COMPANY TO MAINTAIN FULL EMPLOYMENT. IN THIS CASE, THE UNEMPLOYMENT WAS EXPORTED TO THE U. S.

THE TRADING COMPANIES ARE SALES ORIENTED AND THROUGH THE YEARS DEVELOPED WAYS TO GENERATE INDIRECT VOLUME FOR ITS STEEL INDUSTRY INTERNATIONALLY. OF PARTICULAR INTEREST, IS THE AREA OF FABRICATION WHICH INCLUDES BRIDGES AND FASTENERS TO NAME A FEW.

THE JAPANESE ARE PURSUING BRIDGE FABRICATION MARKETS IN THE U. S. THE OVER-ALL CAPABILITY OF THEIR SYSTEM, MAKE IT IMPOSSIBLE FOR U. S. FIRMS TO COMPETE. AS AN EXAMPLE, THE JAPANESE WERE JUST AWARDED A CONTRACT; WITH A BID OF $41,800,000, TO FABRICATE A BRIDGE IN LULING LOUISIANA. THE LOWEST U. S. BID OF $62,933,000 WAS ENTERED BY THE AMERICAN BRIDGE DIVISION OF UNITED STATES STEEL. ANALYSIS WOULD REVEAL THAT THE JAPANESE BID OF $41,800,000 BARELY COVERS THE COST OF MATERIAL. CONTINUATION OF THIS PRACTICE WILL FORCE MANY AMERICAN FABRICATORS OUT OF BUSINESS.

IN THE PAST 12 MONTHS, THE JAPANESE HAVE TAKEN WELL OVER 30% OF THE BRIDGE MARKET IN THE U. S. IRONICALLY DURING THE BOOM OF 1974 WHEN U. S. BRIDGE FABRICATIONS ENJOYED AN UNPRECOUNTED VOLUME OF ORDERS, JOB COMPLETION WAS DELAYED DUE TO SHORTAGES. ALTHOUGH THE STEEL MARKET WAS TIGHT, STEEL WAS AVAILABLE USUALLY AT A HIGH FOREIGN PRICE, BUT FASTENERS WERE IMPOSSIBLE TO GET. THE U. S. CAPABILITY TO PRODUCE FASTENERS HAD BEEN ERODED IN EARLIER YEARS AS A RESULT OF UNFAIR PRICING POLICIES OF OUR FOREIGN SUPPLIERS. CURRENTLY FOREIGN IMPORTS ACCOUNT FOR OVER 50% OF OUR SOURCE OF SUPPLY. U. S. FASTENER COMPANIES ARE CONTINUING TO DROP OUT OF BUSINESS, MAKING THE U. S. YET MORE DEPENDANT UPON UNRELIABLE FOREIGN SOURCES OF SUPPLY.

THIS IS AN EXCELLENT EXAMPLE OF A FOREIGN PRODUCER BUYING A MAJOR PORTION OF AN AMERICAN MARKET. IT ALSO LENDS CREDITABILITY TO THE ARGUMENT THAT THE LOSS OF SUCH PRODUCTIVE CAPABILITY POSES A GREAT THREAT TO OUR NATIONAL SECURITY.

ENERGY PRICES HAVE CREATED PROBLEMS FOR INDUSTRIAL NATIONS AROUND THE WORLD. THE JAPANESE HAVE DEVISED PROGRAMS AND WAYS TO PARTIALLY TAKE ADVANTAGE OF A BAD SITUATION. THE STEEL INDUSTRY IS A MAJOR BENEFICIARY OF THE JAPANESE ENERGY PROGRAM. THE JAPANESE NATION MUST IMPORT MOST OF ITS OIL REQUIREMENTS FOR WHICH IT PAYS CARTEL PRICES APPROXIMATING $14 PER BARREL. ACCORDING TO A RECENT STUDY BY I. V. M. INC. IN WHICH IT STATES THAT IN THE JAPANESE SYSTEM THE STEEL INDUSTRY IS ONLY CHARGED SIX TO SEVEN DOLLARS PER BARREL. THIS ALLOWS THE STEEL INDUSTRY A COST ADVANTAGE WITH WHICH IT CAN GENERATE EXPORT VOLUME WHICH CONTRIBUTES TO JAPAN'S FAVORABLE BALANCE OF TRADE WHICH ENABLES IT TO COVER THE COSTS OF ITS ENERGY REQUIREMENTS.

THE SAME MAY BE SAID FOR ELECTRICAL POWER. THE JAPANESE STEEL INDUSTRY IS THE RECIPIENT OF A HUGE DISCOUNT FROM TRUE POWER COSTS IN JAPAN. THE COST OF PRODUCING ELECTRICAL POWER IN JAPAN, USING MID EAST OIL, IS THREE TO FOUR TIMES THAT OF U. S. UTILITIES USING COAL IN THE STEEL PRODUCING AREAS. YET THE JAPANESE STEEL INDUSTRIES POWER COSTS ARE EQUAL TO OR LOWER THAN ITS U. S. COUNTERPART. THIS CLEARLY DEMONSTRATES THE FAVORED POSITION GIVEN TO THE JAPANESE STEEL INDUSTRY BY ITS GOVERNMENT.

THE U. S. REFERENCE PRICING SYSTEM, WHICH IS BASED ON JAPANESE COSTS OF PRODUCTION, DOES NOT RECOGNIZE THE AFORE MENTIONED EXPORT AIDS. NOR DOES IT CONSIDER ANY OF THE OTHER ADVANTAGES PROVIDED BY THE JAPANESE SYSTEM ITSELF.

THE JAPANESE SYSTEM, AS DESCRIBED, IS CAPABLE OF DOMINATING ITS TRADING PARTNERS IN PRODUCTS OF THEIR CHOICE AND IN ANY MARKET PLACE IN THE WORLD.

TO COMPOUND THE PROBLEM, OTHER NATIONS, INCLUDING DEVELOPING NATIONS, UNDERSTAND THE JAPANESE CONCEPTS AND ARE BEGINNING TO EMULATE THEM IN WORLD TRADE.

BY DESIGN, THE JAPANESE ARE WELL ON THE WAY TO DOMINATING THE WORLD STEEL INDUSTRY BY 1985.

IN THE PROCESS, OUR DOMESTIC STEEL INDUSTRY AND FABRICATING INDUSTRIES ARE SLOWLY BEING DESTROYED AS EVIDENCED BY MASSIVE LAYOFFS AND PLANT CLOSINGS DESPITE OUR COST COMPETIVENESS. THE PRICE THAT THE U. S. IS PAYING FOR UNEMPLOYMENT ALONE IS INTOLERABLE. UNLESS THE U. S. GOVERNMENT ACTS IN RESPONSE TO THIS CHALLENGE AND OFFER FORTH COUNTER ACTIONS TO INSURE THE STABILITY AND GROWTH OF ITS OWN BASIC INDUSTRIAL CAPABILITIES. OUR NATION'S FUTURE COMPETITIVENESS IN DOMESTIC AS WELL AS WORLD MARKETS, FOR AN INCREASING NUMBER OF INDUSTRIES, WILL CONTINUE TO DETERIORATE.

Senator STEVENSON. That is an extremely interesting and helpful statement. I think I will send it to Mr. Frank Weil, just to make sure he realizes that he has got some problems.

We will go through with the rest of the panel and then come back to all of you with questions, time permitting.

Our next witness is Richard Hammer.

STATEMENT OF RICHARD M. HAMMER, SPECIAL COMMITTEE ON U.S. EXPORTS AND MEMBER OF FIRM OF PRICE WATERHOUSE

Mr. HAMMER. Thank you very much, Mr. Chairman, I am a partner in the firm of Price Waterhouse. I am here today to represent the Special Committee for U.S. Exports, which I believe you know about a voluntary group of over 1,200 companies, whose operations include the export of U.S. products.

All of the companies in this group share the conviction that the DISC provisions at the very minimum should be retained in order to enable U.S. business to successfully cope with both the tax and subsidy offered by our foreign competitors.

I think that the other speakers on this panel, as well as the Government witnesses this morning, have brought out the points that many foreign countries offer tax and nontax incentives in the furtherance of export activities.

Therefore, it is my part of this panel to focus in on the tax-related export incentives.

I think it has only been in recent years that the widespread use of such tax incentives has come to the forefront. Within the last 2 years indeed developments in the international trade field have made the use of tax systems to promote exports one of the most pressing, perhaps controversial issue in the trade relations area. There are two controversies in particular, the debate within GATT over the income tax practices of Belgium, France, the Netherlands, and the United States, as well as the litigation in U.S. courts over the imposition of countervailing duties upon imports benefitting from the rebate of indirect taxes that have focused both domestic and international attention on this particular area.

The development and use of tax-related export incentives by many of our foreign competitors I believe should be a particular concern to U.S. policymakers and to U.S. legislators.

Although these practices are, in theory strictly limited by the international rules on export subsidies, the GATT rules, substantial tax-related export subsidies are in fact used to increase the competitiveness of foreign exports.

I would like to categorize the types of tax incentives that are offered by competitive nations in five areas, and make a few comments on each.

Item one deals with exemption of export income. In some countries around the world income from direct export sales is completely exempted from local taxation. I think the most publicized instance of this is Ireland, where both domestic and foreign corporations are granted total exemption from corporate profits taxes through 1990 on profits generated by exported goods products in Ireland.

This, of course, is a country that is within the European Economic Community.

Also in Brazil there is a relatively new export incentive act, where a deduction from taxable income is authorized for income attributable to export sales.

Item 2. Let's talk a little bit about safe haven or territorial rules. I think this is one of the most widely used tax principles which confers benefits on foreign exporters, and that is the special treatment of the taxation of foreign income earned by home country companies.

That is the so-called territorial approach. The foreign branch income of a U.S. parent corporation is fully subjected to U.S. taxes, with an offset for foreign tax credits. In sharp distinction, however, income from an overseas branch of a foreign parent may be treated in a manner ranging from no tax liability at all, to only a fraction of the tax liability born by that corporation on its domestic source income.

Furthermore, if a foreign operation of a non-U.S. multinational corporation is given the legal framework of an offshare subsidiary, particularly if the subsidiary is in a low-rate country, more advantages ensue.

Now the principle of territoriality does apply in some degree to U.S. exports to a foreign subsidiary. However, the United States is unlikely to allow a tax exemption on that sort of income because of our complex subpart (f) rules in the Internal Revenue Code.

However, in many of the major industrialized nations, and these are our principal trade competitors, this same income is not taxed at all. And those countries that do tax it, tax it at substantially reduced rates.

Germany and Canada are the only countries which have adopted an equivalent provision to our subpart (f), to penalize the establishment of subsidiaries in tax haven countries. Japan is about to do so, there have been recent proposals in that regard. However, these countries, including Japan, only penalize passive investment holding company income and not trading income, which is what exporting is all about.

In order to preserve the tax advantages, and thus the export stimulus flowing from the absence of tax jurisdiction over the income of offshore selling branches or subsidiaries, the territorial countries also give special tax treatment to dividends paid by such offshare companies to their parent firms. In United States, as we know, dividends received from any subsidiary incorporated abroad are fully taxed at the ordinary income tax rates, with a foreign tax credit offset.

In these territorial countries, however, these dividends are totally exempt or perhaps almost totally exempt, with a very small margin of local country taxation.

I think the advantages that can be derived from these foreign rules by those in the exporting business in those countries is obvious. By channeling all of their exports either through foreign-based sales office or subsidiaries located in lower tax countries, these escape home country taxation on substantial portions of their income. The result is possible because the home country's does not tax income allocated to the offshore company and then fails again to tax the income when it is repatriated.

Another type of provision offered by some of these countries, which increases the value of the territorial rules, is the deductibility of foreign losses against foreign profits, even though foreign profits are not subject to home country tax.

In a sense, a foreign company in one of these countries can have it both ways. If its foreign branches show profits, the profits are not taxed. But if the foreign branches show losses, it can elect to use these to reduce taxable income currently, although most of these countries do employ a recapture technique which provides a deferral benefit.

Item three, special export tax incentives. These are mainly a system of income tax credits, deductions, and reserves, which are keyed specifically to export operations. A number of countries permit their exporters to establish special tax-deductible reserves to compensate for export credit risks, operational losses and export promotional costs.

A number of countries also permit special deductions for specifically export-related expenses, such as travel and entertainment. A few countries also permit exporters to be exempted from certain domestic taxes, and as an example of this, since 1965, France has had a temporary and refundable 33⅓ percent inflation levy. This is levied on the increase of profit margnis over the preceding year. Transactions associated with exports are exempt from this levy.

In addition to the special tax incentives directly tied into exports, a number of our foreign competitors offer indirect benefits to exporting activities. These are generally what we refer to as depressed area reliefs, where a company is establishing in a depressed area of a particular country, will get substantial tax benefits, such as accelerated depreciation and the like.

Although these are not specifically tied to exports, one must bear in mind that the European countries that offer these incentives export much more, a much higher percentage of their GNP than we do, and in many cases the obtaining of such relievs are contingent to some extent upon a showing that export activity will result.

Item four is administrative practices. This, I believe, is probably one of the key items that we have to deal with in the context of what foreign countries do to encourage exports.

I think the primary point I am getting to in the administration of tax rules by foreign revenue authorities is the area of how does one allocate profits and income among related entities.

Most countries have tax provisions similar to our section 482, which requires the allocation of income between related entities to reflect arm's length dealings. This provision strictly limits and often hurts U.S. exporters selling abroad through overseas subsidiaries.

However, most foreign countries use the counterpart provision in their laws to benefit their exporters. Allocation rules are crucial in determining how much income from exports can escape tax or enjoy a low rate of tax. That is the foreign portion of it. Assuming foreign source income is in one or another of these countries free of home income tax, it is obvious that the more the income that is allocated to foreign sources under these allocation rules, the more of it will enjoy low or nil taxation. On the other hand, if these tax rules are strictly enforced, the benefits from the exemption on foreign source income diminishes. Through lax enforcement of allocation rules, whether or not intended, even more of the export income can escape taxation.

France has been notable in this regard, in that back in 1939, to speak of history, the tax authorities issued another note stating that the intercompany pricing rules should generally not be enforced against exporting companies. In 1973, French tax authorities issued another note providing that these same intercompany allocation rules need not be enforced where a French company can show it did not follow arm's length pricing for "commercial reasons."

The fifth and the last item is one that I dealt with here this morning already, the so-called border tax adjustments. Most of our trading partners rebate substantial indirect taxes imposed on commercial transactions destined for export. In the Common Market in particular, substantially all exports benefit from the remission of the value-added taxes, VAT.

Some of these taxes, I might note, run as high as 30 percent. In addition, exports of a wide range of Japanese products also benefit from a commodities tax rebate which ranges from 5 to 30 percent.

Therebate or remission of indirect taxes on exports was allowed in the international trade rules, which were formulated at a time when economists believed that indirect taxes were always shifted forward in the price of the goods to consumers, but that direct taxes, such as income taxes, were shifted back to the manufacturer.

I believe that a more sophisticated, up-to-date economic analysis has shown that this distinction to a large extent is inappropriate today.

The analysis, I believe, indicates that the shifting of the tax burdens does not depend so much on the type of tax involved, but more on the competitive factors facing the corporation involved.

Taxes must be viewed as an integrated phenomenon, bearing both on domestic and international economic and trade mechanisms. High rebatable indirect taxes compensated for by lower effective corporate taxes, allow corporations the luxury of competitive pricing in the international markets, as well as perhaps a cheap additional source of capital funds.

In a recent white paper, prepared by the committee which I represent today, the tax benefits of the U.S. DISC program were compared with the effects of the export income exemptions and the territorial system rules in six of our important trading partners. I think the lessons of these analyses, which are shown in my prepared statement, are clear.

Even where the comparison of the tax-related export subsidies is limited to the foreign territorial preferences, foreign companies are shown in these figures to have a distinct advantage over their U.S. competitors. The proliferation of foreign tax-related export incentives, which I have outlined briefly for you, have been permitted by the ambiguities, lax enforcement and structure of our GATT rules.

For more than a decade the United States has been pressing for greater fairness in the international trade rules governing the use of tax benefits as export subsidies. The problem with the GATT rule and the reason for their unsuccessful resolution of U.S. attempts to reform them are outlined in appendix D of my prepared statement. Nonetheless, the implications of these foreign tax-related export incentives for U.S. policy is, to my mind, quite clear.

Given the fact that our trading partners offer substantial tax-related export incentives, and these practices do confer a competitive advantage on their exporters, the United States must continue to pursue a policy of bringing more conformity and stricter adherence to the GATT rules on export subsidiaries.

Until such a general review has been achieved, the United States should not only maintain, but also improve its DISC program.

It has been suggested, as you know, by the administration that the DISC legislation be repealed. In my view and in the view of the committee I represent, doing so would be contrary to the goals of the U.S. Government as expressed in the original DISC law, and the intent of the Congress.

Thank you, Mr. Chairman.

[The complete statement of Richard Hammer follows:]

STATEMENT OF

RICHARD HAMMER
PRICE WATERHOUSE & CO.

SPECIAL COMMITTEE FOR U.S. EXPORTS
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
WASHINGTON, D. C.
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TABLE OF CONTENTS

INTRODUCTION

Over the past two decades, two opposite trends in international trade have had a substantial impact on our international trade relations. First, the "Kennedy Round" of trade negotiations during the 1960's resulted in a staged reduction in tariffs. Second, and at the same time certain import duties were being gradually lowered and trade liberalized in that way, the size and scope of foreign export incentives and other non-tariff barriers to trade (NTBs) have escalated. As a result, these export subsidies and other NTBs have assumed a much more prominent role in determining a country's share of international trade and the competitiveness of its manufacturers' products.

The distortions to trade which these NTBs, and export subsidies in particular, have introduced have had serious consequences for the economic well-being of the United States. Trade has become an increasingly important component of the U.S. economy. At the same time, the U.S. share of world exports has fallen sharply, and technology is no longer an American private preserve. This means that the U.S. competitive position in world trade has declined just at the time when that trade has become more significant to our economic health.

The escalation of export subsidies over the past two decades reflects the importance of exports to the economies of many of our trading partners. Exporting is, and traditionally has been, a more important factor in foreign economies

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than in the United States. During 1976, for example, exports from the European Economic Community represented 27 percent of that region's gross product--up substantially from 14 percent in 1955.[1/] Similarly, the ratio of exports to the production of goods in Japan is currently over 30 percent.[2/]

The proliferation of export subsidies also reflects the prominence of exports in the "industrial policies" of our trading partners. On a national level, many countries have pursued policies of "export-led growth" to increase aggregate national demand (and, of course, employment). By the same token, many of these countries have pursued policies of export expansion to offset cyclical declines in domestic demand. The underpinnings of the latter policy is the fact that foreign manufacturers cannot reduce output in response to slack demand because of their heavy debt-financing and their unwillingness (or inability) to lay off workers.[3/] In Germany, for example, economic recovery plans for 1977 posited a growth rate for exports twice that of domestic production. And according to one recent report, it was precisely this consideration which led the Japenese steel industry to seek expanded markets in

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1/ Robert R. Nathan Associates, U.S. Foreign Trade and Employment, unpublished manuscript, 1977.

2/ Lawrence A. Fox and S. Stanley Katz, "Dollar Devaluation, Floating Exchange Rates, and U.S. Exports", Business Economics, January 1978.

3/ Gary R. Gray, "In Defense of the Dollar", New York Times, August 7, 1977.

the United States in recent years, often using unfair competitive practices and with severe impact on U.S. steel companies and workers.[4/]

On an industrial level, scale of production economies require that a relatively high proportion of operating capacity be devoted to exports. Similarly, new industries use a version of export-led expansion to quickly achieve economies of scale, rapid, broad-based market development and "production experience".[5/]

A final consideration, one which has become increasingly important over the past five years, has been the dramatically increased cost of imported oil and raw materials. Our trading partners have pursued vigorous programs of export expansion to offset the impact of increased import bills on their trade and national economies.

Given these considerations, it is not surprising that our foreign competitors have developed broad national programs to: (1) increase their exports; (2) increase the willingness and ability of their manufacturers to export; and (3) increase the competitiveness of their products abroad. What might be surprising, and should be of concern, is the extensiveness of these export programs and their successes. As another recent report has noted:

4/ American Iron and Steel Institute, Economics of International Steel Trade, May 1977.

5/ Stanford Rose, "The Secret of Japan's Export Prowess", Fortune, January 30, 1978.

> What characterizes export policy abroad, particularly in Japan, is that a combination of financial, economic and promotional measures are utilized in which industry and government cooperate closely and coordinate their activities to achieve objectives commonly agreed upon. For example, in Japan the exchange rate has been kept undervalued; government subsidies have been provided for the import of machine tools and raw materials; joint government-industry programs have been applied to penetrate foreign markets in such industries as sewing machines and electronics through selective credit controls; and dual pricing has been practiced. These policies have been quite effective, both in competing in the markets of other developed countries and in the developing countries, where Japan has captured the lion's share of the import growth market. 6/

Included in these broad national export programs are a number of export incentives, subsidies and promotional devices, which may be classed into two groups: non-tax export incentives and tax-related export incentives. Non-tax export incentives include such programs as official credit assistance, insurance guarantees, cash grants, etc. As a general rule, it is these practices which are usually recognized in public discussions as "foreign export incentives", and the competitive effects of such programs are also widely understood.

It has only been in recent years, however, that the widespread use of tax-related export incentives have come to be generally understood. Within the last two years, rapid developments in the international trade field have made the

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6/ Nathan Associates, U.S. Foreign Trade and Employment.

use of tax export incentives one of the most pressing issues in the trade relations area. Two major controversies--the debate within the Council of the General Agreement on Tariffs and Trade (GATT) over the income tax practices of Belgium, France, the Netherlands and the United States, and litigation in U.S. courts over the imposition of countervailing duties upon imports which are subsidized by the remission of indirect taxes--have focused domestic and international attention on this area of international trade law.

Because of the importance of these tax-related practices, and because other witnesses before the Committee will deal with non-tax export incentives in fuller detail than is possible here, the remainder of this statement will focus on tax-related export incentives. Appendix A, however, presents a series of charts which compare both the tax and non-tax export promotional practices of 18 countries. In addition, Appendix B provides country-by-country analyses of the export practices, again both tax and non-tax, of six of our major trading partners (Belgium, France, Germany, the Netherlands, Japan and the United Kingdom).[7/] Together, these discussions

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7/ Information in these appendices and the following description of tax-related incentives is based on a study prepared for the U.S. Department of Treasury by an accounting firm and a law firm. In 1976, the study was updated by the same professionals to make this information current as of January 15, 1976. Additional information has been incorporated from a study prepared by the Special Committee for U.S. Exports during 1977.

provide an overview on the massive panoply of export incentives and subsidies which foreign governments provide to their exporters.

FOREIGN TAX-RELATED EXPORT INCENTIVES

The development and use of tax-related export incentives by virtually all of our foreign competitors should be of particular concern to U.S. policymakers. Although such practices are in theory strictly limited by international rules on export subsidies under GATT, massive export incentives and subsidies have been developed to greatly increase the competitiveness of foreign exports. These practices do so, as will be noted below, by permitting substantial export price reductions, significant increases in export profits and deductions which are applied to the non-price determinants of export competitiveness--or both.

At the outset, it should be noted that the rise of state-trading nations and government-owned corporations has further exacerbated the tax-related export incentive problem. Because such companies are directly subsidized by their governments, the already massive tax benefits outlined below are magnified by the fact that they can manipulate profits and losses to gain additional advantages.

Although the U.S. has only one tax-related export incentive--DISC, foreign countries use many tax-related export incentives, which fall within five basic categories:

(1) non-taxation of export income;

(2) safe-haven rules which permit preferential treatment (or even non-treatment) of foreign branch income, foreign subsidiaries, and dividends from export operations;

(3) special deductions, credits, or reserves for export-related expenses and industrial development;

(4) administrative practices which permit special tax treatment; and

(5) border tax adjustments, including the remission or rebate of indirect taxes.

1. Non-Taxation of Export Income

In a few countries, income from direct export sales is completely exempted from taxation. In Ireland, for example, both domestic and foreign corporations are granted total exemption from income and corporate profit taxes through 1980 on profits generated by the export of goods manufactured or agricultural commodities produced in Ireland. To achieve this exemption, the percentage of export sales to total sales is multiplied by the profit for all sales, and the resulting amount is tax-exempt.

Similarly, the Brazilian income tax reaches only income earned within Brazil. Under the Brazilian Export Incentive Act, a deduction from taxable income is authorized for the portion of income attributable to export sales. And even though such profits are not taxed, the Act permits operating losses to be carried back six years.

2. Safe-Haven Rules

Perhaps the most widely discussed tax practices which confer benefits on exporters is the use of safe-haven rules for the taxation of foreign source income.

The foreign branch income of a U.S. parent corporation is fully subject to U.S. taxation, less allowance for any foreign income taxes actually paid. In sharp distinction, income from an overseas branch of a foreign parent may be treated in a manner ranging from no tax liability whatsoever to only a fraction of that borne by the parent's earnings from home market sales.

If a branch operation of a foreign firm is given the legal framework of an offshore subsidiary, the typical consequences can be even more advantageous, particularly if the subsidiary is established in a lower tax-rate country. While this principle of "territoriality" applies to some degree to U.S. exports through a foreign subsidiary, the U.S. is unlikely to provide an exemption of all taxation because of the provisions of Subpart F of the Internal Revenue Code. However, in most of the major industrialized nations--including our principal competitors in world trade--this same income is not taxed at all and those countries which do tax such income do so at greatly reduced rates. Germany and Canada are the only other countries which have adopted Subpart F equivalents to penalize the establishment of subsidiaries in tax-haven countries.

In order to preserve the tax advantages--and thus the export stimulus--flowing from this failure to tax the income of offshore selling branches or subsidiaries, most foreign governments also give special tax treatment to dividends paid by such offshore entities to their parent firms. In the United States, of course, dividends received from an offshore subsidiary are fully taxed at the ordinary corporate income tax rates. In most foreign countries, such dividends are totally or almost totally exempt from taxation.

The advantages which can be derived from these foreign rules by those in the exporting business are obvious: by channeling all their exports through foreign based sales offices or subsidiaries located in tax-haven countries, they can escape home country taxation on substantial portions of their income. This result is possible because the parent corporation's government does not tax the income allocated to the offshore company, and then fails once again to tax that income which is repatriated by the parent firm.

France, Belgium, the Netherlands, Brazil and Spain provide clear examples of how safe-haven rules are used for export subsidization. France totally exempts foreign source income from taxable income. In addition, foreign source income is defined in a very broad way so as to include any income derived from permanent establishments abroad, from operations abroad of dependent agents, and from operations constituting a so-called "complete commercial cycle" outside France. Under the Complete commercial cycle theory, a French company may derive non-taxable income without a permanent establishment abroad by simply conducting activities outside France. Moreover, the French parent may exclude from its taxable income 95 percent of all dividends received from an offshore subsidiary.

In Belgium, the income of an offshore branch is taxed at one-quarter of the ordinary corporate income tax rate, provided that the income arises from activities conducted abroad and is taxed by the foreign government, regardless, however, of how low that government's tax rate may be. The amount of tax paid in the foreign country is deductible by the parent corporation. Moreover, Belgium does not tax the income of a foreign subsidiary and 95 percent of the dividends received from the subsidiary can be excluded on the tax return of the Belgian parent corporation.

In the Netherlands, a Dutch company is taxed on its worldwide income but it is almost never taxed in practice on income derived from a foreign branch. Foreign source income is taxable only if it has not borne a foreign corporate tax. The rate of such corporate tax is immaterial and it is not required that the tax has been actually levied as long as it should have been levied in in normal circumstances. In addition, dividends paid to a Dutch company by a sales subsidiary in a tax-haven country are free of Dutch income tax if the Dutch company controls as little as 5 percent of the foreign company, and provided that the investment is related to the business activity of the parent. This exemption not only applies to dividends but also to such items as capital gains and interest.

As noted above, the Brazilian corporate income tax reaches only income earned within Brazil. Income earned outside of Brazil by a foreign branch or affiliate is thus free from Brazilian tax. Moreover, the payment of dividends by a foreign subsidiary to a Brazilian parent is also free from tax in Brazil, even where the offshore subsidiary pays no income tax in the country where it is domiciled.

In Spain, the income of a foreign subsidiary is not taxed. Dividends received by a Spanish parent company from a subsidiary are not subject to Spain's 36 percent corporate income tax; however, where the Spanish parent owns at least 25 percent of the foreign company, the Spanish firm can take a credit against its income tax liability equal to 33 percent of the amount of tax payable on the dividends received--even though the income of the foreign affiliate itself was not taxed. This credit, which is available to subsidiaries paying no tax, reduces the effective tax on the dividend to 24 percent.

Another facet of foreign taxation which increases the value of the safe-haven rules is the fact that foreign losses are deductible from domestic profits, even though the foreign profits were not subject to tax. As such, it is a great incentive toward the establishment of new sales operations abroad and substantially reduces the cost of potential losses and the risk of exporting.

For example, a French company can elect to compute its income on a worldwide basis (including profits and losses of its foreign branches) or on a consolidated basis (including the profits and losses of its foreign branches and subsidiaries). This option allows a French company to "have it both ways". If its foreign branches or subsidiaries show profits, those profits are not subject to French taxes. But if the foreign entities show losses, it can elect to use them to reduce its taxable domestic income. Similarly, the losses of a foreign branch are fully deductible by a Belgian parent--even though the income of the branch is taxed at only one-quarter the normal corporate tax rate and may in some cases be exempt from Belgian tax by treaty.

3. Special Export Tax Incentives

In addition to the already substantial export incentive practices noted above, foreign countries have developed extensive systems of special income tax credit, deductions and reserves, keyed specifically to export operations. Such devices include:

a. Tax Deductible Reserves

A number of countries permit their exporters to constitute special, tax-deductible reserves to absorb export credit risks, operational losses and promotional costs. French companies are permitted to establish reserves for the losses of foreign branches and subsidiaries, again even though the profits of such entities are not taxed. The reserve is equal to the amount of capital invested in the foreign company or branch during the first five years of existence or, alternatively (if the entity is located in the EEC) the total losses of the foreign entity during its first five years of operation. In addition, exporting companies are allowed to constitute deductible reserves to cover credit risks; companies which extend two to five year credit can create a reserve of up to 10% of the amount of the credit. If the company continues to sell on such credit terms, it can indefinitely defer a portion of the tax on its export income.

Similarly, Germany permits domestic companies to constitute special reserves for losses incurred by a new foreign-based company, even though it allows current deduction for foreign losses. These reserves apply to the acquisition or establishment of foreign subsidiaries and it is gradually restored to income. However, where a German company exports capital goods in exchange for an interest in a foreign company, it is allowed a tax deferral on the profits realized by creating a deductible reserve which is gradually dissolved after five years.

In Japan, exporters may deduct amounts credited to a reserve for overseas market development. The deductions may go from 1.0% to 1.7% of export value of goods purchased from others, and from 1.5% to 2.3% of all other overseas transactions. Second, Japanese companies with overseas subsidiaries (10% owned or more) can deduct amounts credited to a reserve for losses on their investments in such corporations. Third, Japanese exporters can establish tax-deductible reserves for exchange losses on their net long-term export receivables.

Under Spanish law, corporations engaged in exporting may establish special deductible reserves equal to 50% of their net profits from export operations for (1) future acquisitions of assets to be used in the export business and (2) future expenditures for overseas advertising and marketing.

b. Deductions for Export-Related Expenses

A number of countries permit deductions for expenses tied specifically to exports. In some cases, these deductions are not available to domestic companies and in others are more limited for domestic firms. In Britain, for example, business entertainment expenses are deductible for tax purposes only if the customer entertained resides overseas and is carrying on a trade or business. Similarly, in Japan, export-related entertainment expenses are fully tax deductible, unlike other entertainment expenses whose deductibility is limited.

Other special deductions include accelerated depreciation for export-related production assets (in Spain, companies which export more than 50 percent of their production may take accelerated depreciation of up to 40%); deductions for other export promotion expenses; and special deductions or credits for ocean freight costs.

It should be noted, however, that a number of countries prefer to provide allowances and cash grants to cover the expenses of export activities. In Canada, for instance, the Department of Industry, Trade and Commerce will make contributions to the cost incurred by Canadian companies for pre-contractual expenses for capital projects, market identification and adjustment, participation in trade fairs, the entertainment of foreign buyers, and the establishment of export consortia. While repayment of the contributions is contemplated over three years, it is possible that such grants will not be fully repaid. To the extent that unpaid grants are not realized as income, they can constitute further tax advantages for foreign companies.

c. Exemptions and Credits for Other Taxes

In addition to the special export incentives noted above, a number of countries permit exporters to be excepted from certain domestic taxes or provide credits for foreign taxes. Since 1975, France has imposed a temporary and refundable 33-1/3 percent "inflation levy" on increases in profit margins over the preceding year's margin. Transactions associated with exports, however, are exempted from this levy. In Brazil, commissions paid by Brazilian exporters to overseas agents are exempt from withholding taxes and the withholding tax rate is reduced on royalties and interest paid by exporters to foreign persons or companies. In the Netherlands, a tax credit is given for withholding taxes levied by certain less-developed countries (LDCs) on interest and royalties paid to the Belgian firm by residents in those LDCs.

d. "Tax-Related" Payments

Another tax benefit certain exporters can receive is the remission of other taxes paid. In Italy, Law 639 grants an Italian exporter a remission of a variety of taxes not directly related to the exported merchandise. The nature and amount of this rebate varies from case to case. In Spain, exporters of a wide range of products receive "desgravacion fiscal" payments. Although these payments purport to be rebates of various indirect taxes, they are paid to the exporter even if no such taxes were incurred. The desgravacion fiscal rates vary from product to product, with most rates falling between 10% and 15% of selling price. Similarly, Brazilian exporters receive a "rebate" of the amount of excise and sales taxes which would have been paid had the exported merchandise been sold domestically--i.e., a negative credit on indirect taxes. The term "rebate" is obviously a misnomer, since export transactions are exempt from Brazilian sales and excise taxes.

The list could be expanded almost indefinitely. The ingenuity of modern nations in creating tax export subsidy devices appears to be without limit. Brazil, for example, authorizes other special tax incentives for "trading companies", businesses which purchase manufactured goods solely for export and for manufacturing companies which sell to such "trading companies".

But, in addition to the special tax incentives which are directly tied to exports are a number of incentives which indirectly benefit exports. Every country is concerned with its balanced economic development at the industrial or regional level. In order to encourage the development of certain industrial sectors or of certain depressed areas, all European countries grant tax incentives. While these incentives are not officially or directly related to exports, in practice they often serve as additional export incentives. In a small country like Belgium, large industrial undertakings normally export the great bulk of their production so that any incentive for a substantial industrial operation, whose economies of scale is dependent on export shipments, is largely an export incentive.

That, however, is not the end of the matter. The officials who administer these development incentives determine to whom they can be granted. In France and Belgium, at least, officials will typically inquire about

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the export plans of the applicant and it has been the general experience that the incentives are more readily available when there are plans for substantial exports.

4. Administrative Practices

To the specific tax practices enumerated above must be added tax administration practices which further the advantages of the incentives to foreign companies.

Of primary importance is the administration of rules governing the allocation of profits and income among related companies. Most countries have tax provisions similar to Section 482 of our Tax Code, which requires a reallocation of income between related entities to reflect arm's length dealings. This provision strictly limits, and generally hurts, U.S. sellers abroad. However, most foreign countries have used such provisions to further benefit exporters.

These reallocation rules are crucial in determining the extent to which the income from exports can escape tax or enjoy a low rate of tax. Given that foreign source income is in one way or another substantially free of tax, the more of the income treated as foreign source income under the reallocation rules, the more of income enjoying low or no taxation. On the other hand, if reallocation rules are strictly enforced so that only a small part of the income is foreign source income, the benefits from the exemption or low rate on foreign source income is much less.

The rules of a number of foreign countries are particularly generous to their exporters, requiring considerably less than 75%, or even 50% in some cases, of the income to be taxed in the home country. Through lax enforcement of the reallocation rules, however, even more of the export income can escape taxation. In France, for example, tax administrators issued a Note in 1939 which specifically stated that the intercompany pricing rules should generally not be enforced against exporting companies. In 1973, French tax authorities issued another Note providing guidance that the rules not be enforced where a French company can show that it did not follow arm's length pricing for "commercial reasons".

In Belgium, reallocation rules are infrequently invoked by the Tax Administration as long as the Belgian taxpayer realizes a normal profit. In some cases exporters have received formal assurances from the Administration permitting favorable allocation. While in the Netherlands the reallocation provisions are more strictly enforced, the taxpayer may negotiate advance agreements on pricing for exports. Even in Germany the strict enforcement of these rules has been relaxed from time to time where the German economy as a whole was involved or where exports at cost or at prices below cost permitted full utilization of the German parent's production capacity. In the United Kingdom, British companies can show that the activities of a foreign sales subsidiary will increase exports from the United Kingdom. Such assertions are known to have considerable influence on the attitude of the authorities toward low prices for exports to selected companies.

Other administrative practices which benefit exporters include the ability of foreign companies to negotiate tax "agreements" with their governments. As noted above, such "agreements" can be discussed with respect to intercompany pricing rules. In addition, small and medium-sized French firms can form joint ventures for the purpose of improving their exports and then negotiate favorable "tax agreements" with the government to obtain substantial tax relief.

5. Border Tax Adjustments

Most of our trading partners rebate the substantial indirect taxes imposed on commercial transactions for exports. In the Common Market, substantially all exports benefit from the remission of Value-Added Taxes, with some rates in excess of 30 percent. Exports of a wide range of Japanese products also benefit from commodities tax rebates ranging from 5 percent to 30 percent.

The rebate or remission of indirect taxes on exports was allowed under international trade rules which were formulated at a time when economists believed that indirect taxes were always shifted forward in the price of the goods and direct taxes (such as income taxes) were shifted back to the manufacturer. In view of recent, more sophisticated economic analysis, this distinction is, to a large extent, chimerical. The analysis indicates that the shifting of tax burden does not depend so much on the type of tax as upon competitive market conditions.

It has become obvious that, when rebates of indirect taxes are permitted and rebates of direct taxes are (in theory) forbidden, a country with a comparatively higher indirect tax burden which is rebated on exports has a distinct competitive advantage in world trade. Only recently, and in response to countervailing duties challenges from U. S. companies, that these countries have denied that the indirect-tax system does not work as a special and effective export tax incentive. Indeed, foreign governments have privately stated that indirect-tax systems do have these effects. Moreover, Belgium and Germany, for a time, imposed temporary additional taxes on exports, actions which constitute an admission of stimulative indirect-tax effects on exports.

Taxes should be viewed as an integrated phenomenon, bearing both on domestic and international economic and trade mechanisms. High rebatable indirect taxes, compensated for by lower corporate and individual income tax rates, allow corporations competitive prices in the international market as well as cheap additional capital investment funds and improved cash flow which in turn improve their competitive capacity.

EFFECT OF FOREIGN TAX INCENTIVES

In a recent White Paper prepared by the Special Committee for U. S. Exports, the tax benefits of the U. S. DISC program were compared with the effects of the export income exemptions and safe-haven rules of six of our trading partners.[8/] The clear lesson of these analyses, shown in Appendix C, is clear: even where the comparison of tax-related export subsidies is limited to foreign safe-haven preferences, foreign companies are shown to have a distinct advantage over their U.S. competitors. As noted in Tables 1 and 2, these foreign practices materially increase the competitiveness of foreign exports, through substantial price reductions and/or increased profits and cash flow.

8/ While the U.S. DISC program in some respects is analogous to these safe-haven tax practices, in that it creates a "domestic" safe-haven within the U.S., it should be noted that these practices exempt foreign-source income from taxation while DISC only defers taxation. In this respect, DISC is more analogous to the export reserve systems discussed above.

Table 1

EFFECT OF CERTAIN FOREIGN EXPORT TAX PRACTICES

Increase in After-Tax Profit on $10,000 Sale Attributable to Export Tax Incentive

Belgium	$ 300	(28.7%)
France	$ 280	(28.0%)
The Netherlands	$ 290	(27.9%)
Brazil	$ 200	(14.3%)
Spain	$ 65	(5.1%)
Ireland	$1000	(100. %)
U.S. (DISC)	$ 15.60	(1.5%) 9/

Table 2

Export Price Reductions Made Possible by Tax Incentives

Belgium	$ 330
France	$ 300
The Netherlands	$ 320
Brazil	$ 223
Spain	$ 90
Ireland	$1000
U.S. (DISC)	$ -0- 9/

Source: White Paper: The Increased Importance of DISC as An Element OF U.S. Policy in International Trade, SCUSE, August 1977

9/ It should be noted that the export sale through the DISC does generate an additional cash flow of $240, the amount of the tax deferral. However, that tax will ultimately have to be paid. Thus, this amount cannot be considered either as additional profit or as being available for a price reduction. Because taxpayers can use the cash flow generated by the deferral, it could be considered that the DISC's parent achieves a saving of interest otherwise payable. At six percent, the imputed saving would amount to $15.60, the amount used in the table. It should be noted that this is not actual cash.

THE NEED TO REFORM THE GATT RULES
ON EXPORT SUBSIDIES

The proliferation of foreign tax-related export incentives outlined above has been permitted by the ambiguity, lax enforcement, and inaccurate distinctions of the GATT rules. For more than a decade, the United States has been pressing for greater fairness in the international trade rules governing the use of tax benefits as export subsidies. It has and continues to be the U.S. position--forcefully stated by both Congress and by a series of Democratic and Republican Administrations--that existing international rules place American exporters at a severe disadvantage by allowing other nations to grant massive export incentives. Appendix D reviews the development of these GATT rules, the controversy surrounding them and U.S. efforts over a number of years to reform them.

Briefly, this basic unfairness to the United States under the international rules has two major aspects:

First, despite the fact that, at least in principle, the GATT places strict limitations on the use of direct-tax systems to promote exports, the ambiguity and non-enforcement of the rules have resulted in the proliferation of the substantial direct-tax export promotion systems outlined above. Almost the only exception is the United States, which carefully tailored DISC--its lone tax-related export incentive--to conform to the GATT rules.

Second, the GATT rules give carte blanche to the remission or rebate of indirect taxes on export transactions. As we noted above, this places the United States at a major disadvantage, because it has made a policy choice to rely principally for its revenue on progressive income taxes rather than regressive indirect taxes. The U.S. position is that any policy choice, made for legitimate domestic reasons, should not place a nation's exporters at a disadvantage in international trade.

IMPLICATIONS FOR U.S. EXPORT POLICY

Given the fact that our trading partners use substantial tax-related export incentives, as well that these practices do confer competitive advantages on their exporters, the United States must continue to pursue a policy of bringing more conformity and stricter adherance to the GATT rules on export subsidies.

As we noted above, two recent developments have brought the entire question of tax-related export incentives to the fore and promise a basis for reform. These were the considerations by the GATT Council of the complaint brought against the U.S. regarding DISC and the U.S. counterclaim against tax practices of France, Belgium and the Netherlands, as well as litigation in U.S. courts seeking the imposition of countervailing duties on exports benefitting from the remission and rebate of indirect taxes.

As the U.S. has long requested, these actions should lead to a general review of the GATT code and export tax practices. Indeed, both houses of Congress, in passing the Trade Reform Act of 1974, specifically mandated the U.S. Special Representative for the Trade Negotiations to seek such a review and to pursue a "harmonization" of trade distorting export incentives.

Until such a general review and reform have been achieved, however, the United States should not only maintain but also improve its DISC program. Although it has been suggested that the DISC legislation be repealed, doing so would be contrary to the goals of the U.S. government, as expressed in the original DISC law and by Congress in its authorization for the multilateral trade negotiations. To improve the DISC program--increasing its incentive and providing greater counterbalance to foreign export incentives, Congress should consider expanding the amount of qualified income permitted to be deferred within the context of the incremental rule adopted in 1976.

APPENDIX A

CHARTS COMPARING EXPORT INCENTIVES OFFERED BY THE U. S. AND FOREIGN COUNTRIES

CHART I. Description of Tax Incentives for Exports

Chart II. Description of Nontax Incentives for Exports

Note: Prepared in 1975 and 1976 from various sources including counsel and accountants in some countries and published sources in all. Since published sources cannot be fully current, there may be some changes not recorded.

Chart I

TAX INCENTIVES FOR EXPORTS

	AUSTRIA	PORTUGAL	AUSTRALIA	NEW ZEALAND	JAPAN	CANADA
Taxation of foreign branch income	Fully taxed at usual rate (progressive rates from 30% to 55%). Deduction for foreign taxes paid. Foreign tax credit upon application.	Exemption of 2/3 of income (effective tax rate of 17.4%).	Exempt except if has not been taxed abroad (tax rates from 47.5% to 50%).	Fully taxed at usual rate (tax rates are from 20% to 45%). Foreign tax credit.	Taxable at usual rate (effective tax rate of 52%). Favorable foreign tax credit system.	Fully taxable at usual rate (46%). Foreign tax credit.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	Yes, but under conditions less stringent than under subpart F income.
Deductibility of foreign branch losses	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.	Fully deductible.
Taxation of foreign source dividends	Exempt if at least 25% control.	Exempt if at least 25% control. One-third taxable in other cases.	Exempt in practice.	Exempt.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Exempt when foreign subsidiary is controlled (50%). Partial exemption from 1976. Foreign tax credit.
Special deferrals of taxable domestic income	Investment reserves.	None.		None.	Income may be deferred for: --overseas market development --overseas investment losses --foreign exchange losses	None.
Specific export tax incentives	10% write-off with respect to acquisition of shares in certain foreign entities. Custom free zones.	None.	Deductions and rebates for export market development expenses.	Deduction of 150% of the cost of export related expenditures. Deduction of an amount related to increased export sales.	--Reserves for overseas market development--Deduction of overseas investments. --Reserves for foreign exchange losses. --Special deductions for certain overseas transactions.	None.
Intercompany pricing rules					Favorable treatment for exporting companies.	
Border tax adjustments (VAT)	VAT (rate 18%) zero rate on exports.	None.	None.	None.	None.	None.
Tax incentives indirectly benefiting exports	Accelerated depreciation or tax-exempt investment reserve (1)	Reduced tax rate or exemption from taxation for introduction of new products or processes. Accelerated depreciation.	None.		None.	Tax reduction for manufacturing income. Accelerated depreciation. (1) Investment tax credit.

(1) Most of the tax incentives are granted in connection with industrial and regional development.

TAX INCENTIVES FOR EXPORTS

	BELGIUM	FRANCE	GERMANY	ITALY	LUXEMBOURG	NETHERLANDS
Taxation of foreign branch income	1/4 the usual rate (48%).	Exempt (1) (corporate tax rate is 50%)	Normal tax rate (51%) plus foreign tax credit or, in certain cases, imposition of a flat 25% tax rate.	Taxed at usual rate (35%). Foreign tax credit.	Exemption on 50% of income (progressive tax rate from 20% to 40%). Foreign taxes deductible.	Taxed at usual rate. Favorable foreign tax credit system.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None except if election is made. No subpart F income equivalent.	Yes, but under conditions less stringent than the U.S. subpart F provision.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.
Deductibility of foreign branch losses	Fully deductible even though foreign income is exempt under tax treaty.	Not deductible. (2)	Fully deductible even though foreign income is exempt under tax treaty. (3)	Fully deductible.		Fully deductible.
Taxation of foreign source dividends	Permanent participation (held for more than one year): 95% exclusion plus 5% tax credit. Non permanent participation: 15% tax credit.	95% exclusion if French company owns 10% or more of the stock.	Fully taxed at usual rate. Foreign tax credit and deemed paid foreign tax credit under certain circumstances.	Fully taxed at usual rate. Foreign tax credit.	50% exclusion if at least 25% control. Total exemption for holding companies. Foreign taxes deductible.	Exempt in majority of cases.
Special deferrals of taxable domestic income	None.	Income may be deferred for:--losses of certain foreign business--cost of investment in certain business in LDCs--export credit extended to foreign buyer.	Income may be deferred for:--losses of foreign branches whose income is tax exempt--losses of foreign subsidiaries--profits realized upon an exchange of property for stock of a foreign corporation.		None.	None.
Specific export tax incentives	None.	--Joint export programs--Election to compute income on a worldwide basis--All special deferrals--Exclusion from the "inflation levy".	None.		None.	Tax credit for withholding tax on interest and royalties paid by residents in certain non-treaty LDCs.
Intercompany pricing rules	Will provide assurances on allocation in certain cases. Historically generous to exporters.	As a general rule, not enforced against exporters.	Usually enforced although relaxation may be granted in special circumstances.			Usually enforced but special agreement used. May be negotiated with the tax authorities.
Border Tax adjustments (VAT)	VAT (18% rate) up to 25% for luxury items. Zero rate on exports.	VAT (20% rate) up to 33% for luxury items. Zero rate on exports.	VAT (11% rate). Zero rate on exports.	VAT (12% up to 30% for luxury items). Zero rate on exports.	VAT (rate 10%). Zero rate on exports.	VAT (16% rate). Zero rate on exports.
Tax incentives indirectly benefiting exports	--accelerated depreciation --exemption from real estate tax --reduced income tax rate on certain reinvested profits (4)	--accelerated depreciation --exemption from local business tax --reduction of registration taxes (4)	--accelerated depreciation --reduction of corporate tax rate and VAT rates (4)	Tax exemption or reduction for financial or government owned companies (4)	Investment credit from 3% to 8% of cost of certain capital assets.	Accelerated depreciation (4) Investment tax credit from 8% to 16% of cost of certain capital assets.

(1) Foreign branch income is taxable at usual rate if the French company elects to be taxed on a worldwide or consolidated basis.
(2) Losses of foreign branches are deductible when the domestic company elects to be taxed on a worldwide or consolidated basis.
(3) When the income has not been taxed abroad, the amount deducted for foreign losses must be put back into income after a number of years.
(4) Most of the tax incentives are granted in connection with industrial and regional development.

TAX INCENTIVES FOR EXPORTS

	U.K.	IRELAND	DENMARK	NORWAY	SWEDEN	UNITED STATES
Taxation of foreign branch income	Taxable at usual rate (52%). Foreign tax credit.	Taxable at usual rate. (Average rate 50%). Deduction for foreign taxes paid.	Taxed at half the usual rate (1/2 of 37%). Foreign tax credit.	Exemption on 50% of income (rate is 26.5%).	Taxed at usual rate (effective income tax rate is 54%). Foreign tax credit.	Fully taxable at usual rate (48%). Foreign tax credit.
Taxation of foreign subsidiaries	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	None. No subpart F income equivalent.	Yes, under subpart F provisions.
Deductibility of foreign branch losses	Fully deductible. Deductible against foreign source business income only when carried over to following years.	Fully deductible.	Fully deductible.		Fully deductible.	Fully deductible.
Taxation of foreign source dividends	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.	Fully taxed at usual rate.	Fully taxed at usual rate. Deemed paid foreign tax credit.	Half-exempt if at least 95% control.	Fully taxed at usual rate. Foreign tax credit.	Fully taxed at usual rate. Direct and deemed paid foreign tax credit.
Special deferrals of taxable domestic income	None.		None.	Tax free reserves deductible.		About 25% of taxable income may be deferred under the DISC provisions.
Specific export tax incentives	Deduction of business entertainment expenses connected with export activities.	Exemption from corporate taxes on profits attributable to exports of goods produced in Ireland.		Tax free reserves deductible.	Additional deduction for interest charged on export credit.	None, aside from DISC.
Intercompany pricing rules	Not actively used.				Not actively used.	Strictly enforced, including against export industry. Important cases against exporters pending.
Border tax adjustments (VAT)	VAT (8% rate up to 25% for luxury items). Zero rate on exports.	VAT (19.5% up to 36.5% for luxury items). Zero rate on exports.	VAT (15% rate). Zero rate on exports.	VAT (20% rate). Zero rate on exports.	None.	None at Federal level.
Tax incentives indirectly benefiting exports	Favorable rates of depreciation. (1)	Accelerated depreciation. (1)	Tax-free investment reserves constituted by 20% of annual profits. Dissolved after 10 years. (1)	Accelerated depreciation. Tax-free reserves deductible. (1)	Accelerated depreciation. (1)	Accelerated depreciation. Investment tax credit (10%).

(1) Most of the tax incentives are granted in connection with industrial and regional development.

Chart II

NONTAX INCENTIVES FOR EXPORTS

	AUSTRIA	PORTUGAL	AUSTRALIA	NEW ZEALAND	JAPAN	CANADA
Nontax incentives indirectly benefiting exports	Investment allowances (1)		None.			Cash grants. (1)
Financing assistance	Guarantees for medium-term credits. Rate of interest is 7%.				Direct loans for medium-term sales. Long-term credits at preferential rates (from 7.5% to 8.75%). Financing of contract value from 48% to 64%. Mixed credits.	
Insurance assistance					Are insured: --production risks --commercial risks --political risks --currency fluctuations --loss of foreign investment. Risks are covered from 60% to 80%.	

(1) Most of the nontax incentives are granted in connection with industrial and regional development.

NONTAX INCENTIVES FOR EXPORTS

	BELGIUM	FRANCE	GERMANY	ITALY	LUXEMBOURG	NETHERLANDS
Nontax incentives indirectly benefiting exports	--Interest subsidies --Investment subsidies (1)	--Grants --Investment subsidies (1)	Grants (1)	--Capital grants --Long and medium term loans by specialized government institutions (1)	--Grants --Loans --Guarantees (1)	--Investment subsidies --Interest subsidies (1)
Financing assistance	Discount at low rates. Interest rebates on export credit. Subsidized medium term export financing. Average rate borne by exporters is 9%. Financing of up to 90% of contract value.	Discount at low rates. Long-term loans at 7.5% rate, to both suppliers or buyers. Financing of up to 100% of contract value. Mixed credits.	Discount at low rates. Guarantees. Long-term credits to both suppliers or buyers. Preferential rates of 10%. Financing of up to 80% of contract value. Mixed credits.	Discount at low rates. Interest subsidies. Long-term loans at 8.95% rate to both suppliers and buyers. Financing of up to 100% of contract value.		Discount at low rates. Guarantees. Subsidized medium and long-term export credits. Average interest rate borne by exporters is 9.5%. Financing of up to 90% of contract value.
Insurance assistance	Are insured: --commercial risks --political risks --currency fluctuations Risks covered from 80% to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations --market development --exhibition expenses --inflation risks Risks are covered from 80% to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations --inflation risks Risks are covered from 80% to 100%.	Are insured: --commercial risks --political risks --currency fluctuations --inflation risks Risks are 90% covered.		Are insured: --commercial risks --political risks --currency fluctuations Insurance usually covers from 75% to 100% of the risks.

(1) Most of the nontax incentives are granted in connection with industrial and regional development. In Belgium, interest subsidies are granted for the purpose of investment throughout the country and not only in depressed areas.

NONTAX INCENTIVES FOR EXPORTS

	U.K.	IRELAND	DENMARK	NORWAY	SWEDEN	UNITED STATES
Nontax incentives indirectly benefiting exports	--Grants --Investment subsidies --Interest subsidies (1) --Employment subsidies (2)	--Investment allowances --Training grants --Loan guarantees (1)	--Loans --Cash grants (1)		--Investment allowances --Loan guarantees (1)	None, except limited agricultural subsidies.
Financing assistance	Guarantees. Interest rate subsidies. Portfolio refinancing. Support granted on a supplier and buyer basis. Interest rate borne by borrowers: 7.8%. Financing of up to 100% of contract value. Mixed credits.	Guarantees. Medium-term loans at preferential rates (8%). Financing of up to 80% of contract value.	Guarantees. Financing of up to 80% of contract value. Interest rate is 8.5% after first year.		Medium and long-term financing at 2% or 3% above discount rate. Financing of up to 100% of contract value.	Discount at medium rates. Guarantees. Long-term export credit financing at interest rates from 8.25% to 9.5%. No mixed credits. Financing of 30% to 55% of contract value.
Insurance assistance	Are insured: --commercial risks --political risks --production risks --inflation risks --currency fluctuations --performance bonds Risks are covered up to 100%.	Are insured: --production risks --commercial risks --political risks --currency fluctuations Risks are covered up to 100%.	Are insured: --commercial risks --political risks --currency fluctuations Risks are covered from 85% to 90%.		Are insured: --commercial risks --political risks --currency fluctuations --inflation risks Risks are covered up to 90%.	Are insured: --commercial risks --exhibition expenses --political risks Risks are covered up to 95%.

(1) Most of the nontax incentives are granted in connection with industrial and regional development.
(2) Granted in order to encourage employers to retain employees.

APPENDIX B

DESCRIPTION OF EXPORT SUBSIDIES OFFERED BY SIX MAJOR TRADING NATIONS

A. BELGIUM

B. FRANCE

C. GERMANY

D. THE NETHERLANDS

E. JAPAN

F. UNITED KINGDOM

A. BELGIUM

I. Tax Incentives.

1. Taxation of foreign source income.

a. Rules for direct exports.

Under Belgian domestic law, foreign branch profits and foreign source real property income are taxed in Belgium at a reduced rate. Such income must have been "generated abroad," that is, the activity which produces such income must be conducted abroad, and in the case of foreign branch profits, it must have been taxed abroad. The rate of tax is not relevant nor are any special rules exempting the income from foreign tax as long as the income is actually or should have been taxed at regular rates. The reduced rate is one-fourth the rate applicable to income from domestic sources, meaning that presently, foreign source income is generally taxed at a 12 percent rate. Foreign taxes can be deducted from taxable income. Under most Belgian tax treaties foreign source income is exempt from tax in Belgium. Foreign branch losses are fully deductible by the domestic parent even though income of the branch would be exempt from tax in Belgium under a tax treaty. Certain rules apply regarding the order in which foreign losses may offset taxable profits. If the loss is incurred in a non-treaty country, the loss is applied first against foreign source income from non-treaty countries, secondly against foreign source income exempt by treaty and thirdly, against Belgian source income. If the loss is incurred in a treaty-country, the loss is applied first against foreign source income exempt under the tax treaty, secondly, against foreign source income from a non-treaty country, and thirdly against Belgian source income. If the Belgian operation results in a net loss, the loss is applied first against Belgian source income then against foreign source income from a non-treaty country, and thirdly against foreign source income exempt by treaty.

b. Rules for exports through a subsidiary.

Income from a foreign subsidiary is not taxable in Belgium and there is no provision comparable to Subpart F of the U.S. Internal Revenue Code. Therefore, a Belgian company can freely take advantage of the establishment of a foreign sales subsidiary located in a tax haven country.

2. Use of intercompany pricing rules to benefit exports.

Unlike France, Belgium has no published circular with respect to intercompany allocations involving exports through a related company in a low tax country. Nevertheless, favorable intercompany pricing has been permitted by the Belgian government, especially in the late 1950's and early 1960's, as a means to encourage the establishment of export industries. Although the Belgian tax authorities have the power to reallocate profits under Article A.24 of the Belgian Revenue Code, it appears that, in practice, they have had considerable difficulty in obtaining adequate information to enforce that provision. Moreover, the Belgian government has issued formal letters to potential foreign investors with respect to intercompany allocations on exports which apply for a limited number of years. For example, the Belgian authorities have agreed to accept prices equal to cost plus 8 percent. These letters are sometimes extended. However, in recent years it has been more difficult, but not impossible, to receive such formal assurances and the profit required in Belgium will depend more on industry norms than in the past. Nevertheless, letters are still being issued.

3. Specific tax incentives indirectly benefiting exports.

a. Depreciation.

No special depreciation or amortization is allowed on assets connected with the production of goods to be exported. However, such advantages are granted for other purposes which indirectly benefit the export industry. Special depreciation rates must be agreed upon with by the tax authorities which may allow degressive depreciation, accelerated depreciation and other special advantages. These advantages are mostly granted in connection with the development of certain depressed areas or industries. In various development areas, the cost of equipment, tools and industrial buildings can be depreciated at an annual rate which is equal to twice the normal straight line depreciation during a maximum period of three years.

b. Exemption from real estate taxes.

The government may grant an exemption from real estate taxes on fixed assets for a maximum period of five years. As in the case of depreciation, this measure is primarily aimed at industrial and regional economic development. There is indication however, that the administration is usually strongly influenced by actual or potential exporting activities of an applicant.

c. Profits realized from the sale of fixed assets and shares.

Profits realized on the sale of land and buildings, machinery, equipment and shares may be subject to a reduced income tax rate when the proceeds are invested in a development area within a period beginning 6 months before the tax period during which the profits are realized and expiring 12 months after the end of such tax period.

II. Nontax Incentives.

1. Nontax incentives directly benefiting exports.

a. No import tax or custom duties are imposed on merchandise imported into Belgium, as long as it is reexported within a short period of time, and that it is not used or transformed in Belgium.

b. Export financing.

Belgian companies may discount commercial paper received in export transactions at a rate usually more favorable than that applied to commercial paper resulting from domestic transactions. Such rate is fixed and controlled by the government. Under governmental supervision, a special banking institution grants medium term export financing at rates competitive with other countries. A majority of loans at even more favorable rates is intended to encourage exports to developing countries. Besides, under the Compromex program, interest rebates are granted on export credits. The charge is borne by the government and the interest burden may be reduced, for instance, from 7 percent to 5 percent. The average rate of interest borne by the exporter is 9 percent.

c. Credit insurance.

A special government agency called the "Office National du Ducroire" insures long-term export credits against general commercial and political risks as well as any losses which might arise due to currency fluctuations. Coverage of risks ranges from 80 percent to 100 percent.

d. Government subsidized services to exporters.

--Office Belge du Commerce Exterieur.

This government agency provides for assistance to exporters in the following areas:

market studies and planning;
practical information regarding commercial regulations and techniques;
publications;
documentation (Diplomatic reports, statistics);
legal help;
advertising assistance;
participation in commercial and industrial fairs; and
organization of business conferences.

--Exporbel

This organization grants assistance for export promotion to small and medium enterprises. It acts as a consultant for the company and might go as far as organizing a distribution network abroad, searching buyers, collecting debt, packaging, shipping and insuring goods for the exporter.

2. Specific nontax incentives indirectly benefiting exports.

a. Stimulation of exports is not the primary purpose of the various subsidies granted by the government in order to develop investments and stimulate regional development. But such measures sometimes have the effect of encouraging exports because subsidies are more easily granted when the industry is a potential exporter.

b. Among the incentives granted by the government are:

--Interest subsidy under which the government subsidizes a portion of the interest payable by the investor on the loan. The subsidy is generally 2 percent during a period of two years usually given on an amount between 1/2 percent and 2/3 percent of the investment in fixed assets. But when the investment is made in a development area, the rate of the subsidy can go up to 7 percent during a period of five years on an amount not exceeding 75 percent of the total investment cost.

--Direct financing of investments in lands, equipment, machinery, and buildings.

--Non-interest bearing loans of up to 50 percent of the proposed investment may be granted to finance research and development of new products and new production techniques to be employed in Belgium.

--Financial assistance to meet the cost of training workers.

--Government guarantees covering capital repayment, interest and other charges relative to medium term qualifying loans.

B. FRANCE

I. Tax Incentives.

France is certainly the most aggressive country, together with Japan, with respect to encouraging exports. It is one of the few countries which allows direct tax incentives to its exporters. Besides, its basic tax structure has an especially favorable impact on the export trade.

1. Taxation of foreign source income.

a. Rules for direct exports.

Foreign source income is not subject to French income tax. Domestic source income is "all profits realized by enterprises exploited in France." As interpreted by the courts, foreign source income is therefore any income:

- --derived from establishments abroad;
- --derived from operations abroad of dependent agents; and
- --derived from operations abroad which constitute a "complete commercial cycle."

In other words, the exclusion applies to income derived from the direct and active conduct of a business abroad either by a French company or by a foreign company. As a result, income of the foreign subsidiary of a French company as well as income from a foreign establishment is not taxed in France because the profits are attributable to activities conducted abroad. Similarly, profits derived abroad by a French company's agent from strictly foreign activities are not taxed in France. Moreover, certain income is considered as foreign source income even though the French company has no establishment or agent abroad. This is the case of income derived from a "complete commercial cycle" abroad. The income derived by a French company purchasing goods in country A for resale in country B is excludable, but the contracts must usually have been negotiated and executed outside France.

b. Rules for exports through subsidiaries.

Income of a foreign subsidiary is not taxable in France and France does not provide for any provision comparable to Subpart F of the U.S. Internal Revenue Code. There is no credit for foreign taxes paid unless a tax treaty so provides, but a French parent corporation is entitled to exclude 95 percent of the dividends received from a foreign subsidiary. In order to qualify for the exclusion, the French company must own at least 10 percent of the outstanding stock of the foreign corporation. Upon subsequent distribution to its stockholders, the French company might be liable for the precompte mobilier, which is a supplementary tax equal to 33 1/3 percent of the gross amount of tax-exempt dividends received from foreign subsidiaries. But the corporation is free to determine whether the distribution is made out of previously taxed or untaxed earnings, and as long as taxed earnings exceed the amount of distribution to stockholders, the corporation may escape the supplementary tax. Moreover, shareholders are entitled to tax credits equal to 50 percent of the cash dividend.

2. Use of intercompany pricing rules to benefit exports.

Article 57, C.G.I. authorizes the French authorities to re-allocate income between members of an affiliated group. With respect to exporting companies, the administration has officially stated that in dealing with French firms which have subsidiaries or branches abroad engaged in the export trade, it will not insist upon a strict application of such provision, "in order to permit the maximum development of exports and to aid in the establishment of enterprises intended to sell French products abroad." The statement provides further that companies which possess an exporter's card may sell to foreign affiliates at a price approaching its cost provided "the transaction is motivated by commercial necessity other than the desire to transfer profits abroad" (Note No. 893 of August 31, 1959, M.O.C.I. of September 26, 1959, Annex O). This statement raised strong protestations in the United States and the French Administration has issued a new Note in May 1973. Even though the exporter's card was abolished in 1973, there is no indication that the Administration has changed its policy of not strictly enforcing Article 57 against French companies engaged in exporting. In fact, the 1973 Note simply reiterates the position of not systematically applying Article 57 if commercial considerations rather than the transfer of profits can be proved to be the motivating factor. (B.O.G.D.I. 4A-2-73 dated May 4, 1973). Such an attitude is of fundamental significance. It converts the French basic tax structure with respect to taxation of foreign source income, into direct export incentives.

3. Specific tax export incentives.

a. Election to be taxed on a worldwide or consolidated basis.

Upon authorization by the Ministry of Finance, French companies can elect to compute their French taxable income on a worldwide basis by adding together the profits and losses of their French and foreign branch activities. Another alternate election is to make a computation on a consolidated basis for all branches and subsidiaries, either domestic or foreign. Under each system, credit is given for foreign taxes with per-country limits of the French tax rate. The advantage of using either method is that losses from foreign operations can be used to eliminate otherwise taxable profits from French operations. This provision was enacted to put French oil companies on a par with the U.K. and U.S. oil companies. However, election of group taxation is not limited to oil companies.

b. Special reserves for losses of foreign businesses.

In spite of the fact that profits of foreign branches or subsidiaries are not taxable in France, Article 39 octies A, C.G.I., as amended in December 1974, allows a French company which establishes a foreign sales, research or information office or subsidiary to constitute a special deductible reserve equal to:

a) For activities established in the EEC countries, the lower of

  i) losses (determined in accordance with French rules) incurred during the first five years of operations, or

  ii) the capital invested in said branch or company during the first five years.

b) For activities established in other countries, with the exclusion of tax havens, the reserve can equal the amount of capital invested during the first five years.

For both (a) and (b), prior authorization must be sought from the Ministry of Finance but is deemed given if not refused within two months after the application was filed. It should be noted that these foreign situtated activities must be of a nature that contributed to the sale of products manufactured in France (i.e., increase exports).

The reserve is gradually restored into taxable income starting the sixth taxable year following the first investment over a five-year period.

c. Special reserves for investments in developing countries.

French companies which establish industrial investments (e.g., manufacturing processing) in certain foreign countries, listed by the Ministry of Finance (basically developing countries) can, upon authorization from the Ministry of Finance, establish a reserve in deferral of French tax equal to a miximum of one-third of the capital invested during the first five years of operations or for investments made after January 1, 1975, the reserve can equal a maximum of one-half of invested capital.

All reserves are to be added back to taxable profits in the same way as mentioned above.

27-039 O - 78 - 11

d. Joint export programs.

When small or medium sized businesses coordinate to make a joint effort to improve their businesses and set up a company for the purpose, they can negotiate a tax agreement with the Minister of Economy and Finance. This agreement gives them substantial tax and nontax advantages which vary from case to case. This program is made specifically applicable to joint export programs. The following advantages are currently available to an approved company:

--medium and long-term loan funds from public sources;

--rediscount facilities for drafts drawn by the shareholders upon the company;

--the shareholders investment in the stock of the company is deductible in the year made;

--the company, however, may depreciate its assets in the usual manner; and

--capital gains upon the sale of shares in the company may be reinvested without taxation within one year in shares of a similar company.

The company is not eligible to deduct its expenses for the establishment of a foreign office. It may however, obtain insurance from COFACE.

e. Deductible provisions for banks.

Banks and similar financing establishments which have granted loans to finance exports or foreign trade are allowed to constitute deductible provisions to cover the risks attached to these credits.

f. Special reserves for export credit.

Exporting companies which extend medium term credit are entitled to create a special deductible reserve to cover the risks inherent in the extension of credit abroad. Credit terms must be between two and five years. However, any extension of credit which is guaranteed by the government insurance corporation is entitled to this special deduction regardless of its duration. The amount of the deductible reserve cannot exceed 10 percent of the credit and the amount deducted must be restored, but not until the final payment of the credit granted has been made. Such a provision allows a company to indefinitely defer a portion of its income, as long as it is engaged in the exporting business.

g. Exclusion of exports from the "inflation levy."

France introduced a new law, effective January 1, 1975, which is aimed at fighting inflation by penalizing business "margin" increases which are not the result of an increase in employment, exports or investments. The law imposes a temporary and refundable levy on the increase of a business enterprise's margin of a financial year over the preceding financial year's margin. The margin is the difference between purchases and sales (value added) in a given year, with certain adjustments. The rate of the levy is 33 and 1/3 percent. However, in order not to hurt export sales, the law excludes from the margin computation all transactions which are made in connection with exports. In other words, export income is excluded from the new inflation levy. The inflation levy provisions were extended to 1976.

4. Specific tax incentives indirectly benefiting exports.

A number of tax incentives are granted by the French government in order to promote industrial and regional development:

--exemption from local business tax up to a maximum of five years;

--reduction of registration tax from 16.60 percent to 4.8 percent in the case of purchase of a going business, and from 20 percent to 5.28

percent in the case of the purchase of land; and

--accelerated depreciation of construction costs: 25 percent upon completion of the building.

These advantages are granted only to investments made in development areas. In order to promote industrial concentration, the government also allows losses of the absorbed or contributing company to be carried over by the surviving company. Moreover, if the dissolution of a company is found to improve the French economy, capital gains and reserves distributed upon liquidation are taxed at a fixed rate of 15 percent. These advantages are granted upon special authorization of the Ministry of Finance, and the practice shows that the existing or potential exporting activities of the applicant company generally induce a favorable decision.

II. Nontax Incentives.

I. Specific nontax incentives.

a. Export insurance programs.

A government corporation created in 1948 (COFACE) provides French exporters with extensive insurance coverage. The credit guarantees covered by COFACE can be classified in 9 categories:

1) Production risk: guarantees against sudden interruption of sales and resulting losses to the manufacturers or exporters prior to export.

2) Credit risk: guarantees against the risk of non-payment by the foreign purchaser once the goods have been exported.

3) Accident risk: guarantees against damage to exported goods prior to their delivery.

4) Commercial risk: guarantees against the insolvency of the foreign purchaser.

5) Exchange risk: guarantees against currency fluctuation, devaluation and revaluation.

6) Inflation risk: guarantees against cost increases of executing the contract. This coverage is not available for goods exported to E.E.C. countries.

7) Market development risk: guarantees against expenses related to initial foreign operations including start-up expenses and the building up of inventory abroad.

8) Exhibition expenses: guarantees participation in industrial fairs (excluding fairs held in E.E.C. countries) by covering expenses incurred, including rental and preparation of the stand, publicity costs, living and travel expenses of representatives and the cost of returning the goods exhibited to France.

9) Political risk: guarantees against acts of foreign public authorities.

Short-term guarantees issued to COFACE are valid up to 180 days and are generally applicable to the sale of consumer goods. Light durable goods and merchandise delivered in a series can be covered up to 3 years.

Prior to March 1974, COFACE limited its short-term guarantees to countries where the political and commercial risks were not too high. Some of the countries excluded produced oil and raw materials. In order to promote French exports to these previously excluded countries (e.g., Nigeria, Brazil, Indonesia), the Council of Ministers on March 20, 1974 decided that the French Treasury would assume the commercial risks, which means that COFACE now can insure French exports to these countries.

Medium and long-term COFACE guarantees for the manufacture of heavy durable goods, plant installations, and public works contracts are available but require special authorization from an inter-ministerial commission. Special contractual terms and conditions are required to be specified.

Coverage of the risks is 90 percent for political risks and 85 percent for commercial risks.

The market penetration risk insurance covers 50 to 70 percent of future losses from a market development effort during a period of three to five years. The exhibition expenses insurance provides for an immediate payment to a person showing its export products at an international fair equal to 80 percent of all expenses mentioned above. In these two types of insurance, the insured is required to repay the amounts received when profits exceed expenses. But he has had the advantage of that much tional working capital for the period.

b. Export financing.

Credit to buyers and suppliers are generally used to support both medium and long-term export transactions. In France the government-related institutions dealing with export financing is the Banque Française du Commerce Exterieur. (BFCE)

In cooperation with French commercial banks, the BFCE limits its support to long-term credits. Medium-term suppliers' credits are supported by the Bank of France (Central Bank) by way of refinancing the early maturities thereof and by establishing interest rates for export financing in cooperation with French commercial banks and the BFCE. Such discount rates are usually below the market rates. The Bank of France discounts the early maturities of both medium-term export paper (18 months to 7 years) and the medium portions of longer-term export credits. Export credit insurance is a pre-requisite for refinancing.

The BFCE extends direct long-term loans on both a supplier and buyer basis. Exportation of all goods and services including capital goods are eligible for support. Generally up to 90 percent of the contract value is supported

(100% in some cases). The interest rates charged borrowers for such long term export credits are generally 7.5 percent. The BFCE also provides for long-term "mixed loans" which are a combination of normal commercial terms with "soft terms" such as special long-term loans with extremely low interest rates. The portion of the long-term loans so subsidized varies from case to case.

c. Exporter's card.

Although the "Exporter's Card" was abolished by decree, March 27, 1973, it was expressly stated that the various advantages previously granted to cardholders were to be maintained.

A manufacturing company was usually entitled to an exporter's card if at least 20 percent of its gross sales consisted of exports, sales with France to nonresidents, royalties for the use outside of patents and know-how and certain advertising revenues. An exporter's card gave substantial advantages, such as market promotion and exhibition insurance coverage equal to 60 percent of the respective expenses for these activities (50 percent for other companies), duty free imports of export related goods up to an amount equal to 10 percent of the company's exports, and non-enforcement of the provisions under Article 57 of the C.G.I. relating to intercompany pricing rules.

2. Nontax incentives indirectly benefiting exports.

Investment incentives aimed at the development of depressed areas and at deconcentration of the Paris region, serve indirectly as an incentive to export to the extent that a company which is an important or potential exporter may obtain the incentives more easily. So far, this has been the usual administrative practice. The main advantages can be listed as follows:

a. Industrial development and adaptation grants are available up to 25 percent of the investment in the case of the erection of new facilities and up to 20 percent in the case of conversion or extension of the facilities. The investment must exceed approximately $120,000 and create at least 30 employments or increase employment by 30 percent.

b. Localization grants are available for companies establishing their headquarters outside Paris. The grant may amount from 15 to 20 percent of the investment made. It must create employment for at least 100 persons (50 in the case of research and development facilities).

c. Decentralization indemnity.

Enterprises moving their production facilities outside Paris are granted indemnities to cover moving expenses. The grant may cover up to 60 percent of the total expenses. Employees of such enterprise are also granted reimbursement for their transportation and reinstallation expenses.

d. Training subsidies.

Subsidies may be granted for the training of unskilled labor and for in-plant training. It may consist of 60 percent of the salary of the instructors and of the trainees and 100 percent of the expenses of training the instructors.

Apart from incentives aimed at regional development, the government grants also additional incentives for economic development in general such as special loans at a low rate of 8 to 12 year duration for investments of special economic interest.

GERMANY

I. Tax Incentives.

1. Taxation of foreign source income.

a. Rules for direct exports.

A German company is taxed on its worldwide income. The income from a foreign permanent establishment is computed under German rules and added to the head company's income. The law provides for a foreign tax credit, but only to the extent of German rate on that same income. However, most tax treaties exempt profits of foreign branches from German taxes. Where this is the case, the German head office may, upon application, still deduct its foreign establishment's losses from its domestic income. The losses are first taken against any profits of other permanent establishments located in the same foreign country and then against domestic income. The unabsorbed balance of loss can be carried forward over a five year period. When sufficient profits are subsequently derived from the establishment(s) in the host country to offset the losses, the amount of losses deducted in Germany must be restored. This prevents a double deduction, but it does provide for an immediate tax benefit when a new permanent establishment incurs start-up losses.

b. Rules for exports through a subsidiary.

Income of a foreign subsidiary is not taxable in Germany. However, if a subsidiary is domiciled in a country with low taxation and is not active itself, the income of this subsidiary may be deemed to be income of the German parent company. Taxes paid by the subsidiary on this income may, upon application, be used as tax credit in Germany. This provision is somewhat equivalent to subpart F provisions under the U.S. Internal Revenue Code, although less stringent.

Dividends received from a foreign subsidiary are taxable to the parent company unless a tax treaty provides otherwise. Under most German tax treaties, Germany does not include in income dividends received from subsidiaries where the German parent owns 25 percent or more of the stock of the subsidiary. Where dividends are taxed, there is a credit for foreign taxes withheld at source. Except in the case mentioned above, no credit is granted for foreign taxes paid by the subsidiary on corporate income.

c. Reduced tax rates.

--Where no tax treaty exists, however, foreign source income may still receive very favorable treatment. First, a German corporation is taxed at the rate of 51 percent but on its undistributed profits only. Profits which are intended for distribution to shareholders are taxed at the reduced rate of 15 percent. This provision applies to any type of income wherever derived from.

--Moreover, under certain conditions the Federal Minister of Finance can grant complete or partial forgiveness of tax on the foreign source income of a resident taxpayer, or determine the tax on such income at a flat rate. The first condition is that the granting of either relief measure would be in the interest of the German economy as a whole. The second condition is that the application of the foreign tax credit would present unusual problems in an individual case.

Taxation at a flat rate (25 percent) applies to income from foreign unincorporated entities or from an investment in a foreign commercial entity located in nontax treaty countries. The entity must be exclusively or almost exclusively engaged in the production or delivery of merchandise abroad, the rendering of services abroad or the importing of merchandise from a foreign country into Germany. In the case of a foreign commercial entity, the investment must amount to 25 percent or more of the entity's share capital. Since the 25 percent tax rate is a substitute for the usual tax rate and foreign tax credit, the election for the flat tax rate becomes more advantageous as the foreign tax rate decreases. It is therefore an incentive for the establishment of sales companies or establishments in low tax countries. However, even though the income is distributed to shareholders, it cannot benefit from the reduced tax rate applied to distributed corporate profits. On the other hand, losses incurred by these establishments whose income is taxed at the flat tax rate are fully deductible by the German head office. Although provisions exist in German law which penalize the establishment of subsidiaries in tax haven countries, the scope of their application is substantially limited by the fact that there are other means for German companies to have foreign source income taxed at low rates or not taxed at all.

d. Special provisions for deferral of taxable income.

--Under restrictive conditions, a foreign subsidiary's losses may lead to a deferral of taxes on the parent's income. Upon acquistion or establishment of a corporation abroad, the German parent may constitute a deductible reserve for the loss of the subsidiary to be allocated to the percentage of shares owned, (but the amount of reserve can never exceed the book value of the initial investment). This reserve must be restored to income after five years or as soon as profits have made up the losses. The subsidiary must generally be 50 percent owned. A 25 percent ownership is permissible when the corporation is situated in a developing country. The foreign subsidiary must be either a manufacturer or distributor, or must be an agency or perform trade services. The same provision exists in French tax law but does not have the same purpose. The French provision was more especially directed at the establishment abroad of offices which would serve as antennas for developing the parent's exports. The German provision is aimed at boosting the establishment of foreign manufacturing concerns and capital exports but it obviously is advantageous to foreign based sales companies.

--This provision is supplemented by tax deferral devices to encourage export of capital goods in exchange for an interest in a foreign company. The German parent is allowed to defer German corporate income tax on the profits realized on the transaction by creating a deductible reserve equal to the profit. The reserve is gradually dissolved after five years at a minumum rate of 20 percent over a period of five years. The reserve can only be created if the companies, partnerships, businesses or branches in the foreign country are engaged in one of the activities which qualify for concessions under the developing aid laws enacted in 1969, i.e., the production or sale of merchandise, the extraction of natural resources, commercial services or agriculture and forestry.

--All these various tax provisions, which are primarily aimed at encouraging capital export and foreign direct investments, certainly provide substantial advantages as well to foreign sales companies.

27-039 O - 78 - 12

2. Enforcement of intercompany pricing rules.

As opposed to other European countries, Germany has a policy of strict enforcement of the intercompany pricing rules, much similar to the U.S. tax authorities attitude. Intercompany pricing has always been an item to which the German tax auditors have paid particular attention. Where income of a foreign branch is exempt from German income tax by reason of a tax treaty, the authorities generally subject the intercompany transfer prices between the German company and its foreign branch to a detailed examination. It is known, however that this rule has been relaxed from time to time and that exports by German manufacturers at cost or at prices below cost have been approved in special situations. Apart from instances in which an overriding interest of the German economy as a whole was also involved, relaxation of the rules has sometimes been allowed in situations where a German company operated at less than capacity and production for a foreign subsidiary permitted full utilization of the parent's capacity.

3. Various tax incentives indirectly benefiting exports.

a. Under the Berlin development law, a number of tax incentives are granted to encourage the economic development of this area:

--accelerated depreciation of up to 75 percent on depreciable fixed assets acquired for a Berlin branch;

--lower income and corporation profits tax rates on the profits of a Berlin branch; and

--special value added tax concessions on goods manufactured in Berlin and shipped to the Federal Republic. The Berlin manufacturing company is entitled to turnover tax preference of either 4.5 percent, 5 percent, or 6 percent of the invoice amounts of its shipments to West German purchasers. The West German purchaser is entitled on the other hand to a turnover tax preference of 4.2 percent of the income price of goods purchased from Berlin.

b. Other special German laws grant various other tax incentives mainly intended for economic development of Eastern areas. The most significant of these incentives is an accelerated depreciation of up to 30 percent for immovables and up to 50 percent of the cost of movable fixed assets that are used in businesses located at the East border of West Germany.

c. Accelerated depreciation is also generally granted in respect to special fixed assets such as those used for sewage disposal, reduction of air pollutio ain mining equipment, research and development equipment. These incentives are not designed to promote export but it is clear that where incentives are granted, the benefits resulting therefrom are not restricted to domestic sales of a company's products. Export sales also benefit from these incentives.

II. Nontax Incentives.

1. Specific nontax incentives directly benefiting exports.

a. Export guarantees through HERMES.

HERMES is a government-sponsored insurance company whose function is to guarantee exports by assuming part of the obligation for uncollectable receivables (commercial risks) or for the manufacturing cost of equipment if the goods ordered are not taken over by the foreign customer (production risks). As a rule, 10 to 20 percent of the risk must be borne by the foreign exporter. The institution also insures such other risks as rate of exchange fluctuations, inflation and political risks.

b. Export financing.

In the case of export receivables financing is possible either with private banks or with a government-owned institution at preferential rates. Private banks purchase only such receivables which have not been guaranteed by HERMES. The financing of export transactions by a government-owned institution is available only in the case of exports to developing countries and export of ships. In such cases, long-term credits may be extended on both a supplier and buyer basis. The percentage of contract value supported generally varies from 70 to 80 percent for buyer credits and it is slightly lower for supplier credits. Like France and the U.K., Germany provides "mixed credits."

c. Technical assistance.

The German government provides assistance to exporters by making information available on the import requirements of individual foreign countries, import procedures, legal questions, customs duty rates, available financing, etc. In addition, a government agency exists to provide assistance to German firms participating in foreign trade fairs.

2. Nontax incentives indirectly benefiting exports.

Germany grants substantial economic development subsidies which may have a beneficial effect upon export trade. Most of these subsidies are in the form of cash grants allowed for economic development in selected areas. The cash grants are computed after a given percentage of the cost investment. The percentage ranqes from 5 percent to 30 percent of the cost of the investment.

D. THE NETHERLANDS

I. Tax Incentives.

1. Foreign source income.

a. Rules for direct exports.

Although a Dutch corporation is taxed on its worldwide income, it is almost never taxed in practice on income derived from a foreign branch. To avoid double taxation on foreign source income, the Netherlands has concluded tax treaties with many countries, under which either foreign source income is exempt from tax by the source country or the foreign tax imposed reduces or eliminates the Dutch tax on the income by means of a tax credit.

Where relief is not provided by treaty, Netherlands law provides unilateral relief from double taxation on foreign source income from a foreign permanent establishment, provided the permanent establishment is subject to foreign income tax on said income. The Dutch tax is reduced by the amount which bears the same ratio to the Netherlands corporation tax liability on taxable income as the foreign source income bears to taxable income.

Example:

Foreign source income	Dfl.	100,000
Netherlands source income	Dfl.	700,000
Taxable income	Dfl.	800,000
Tax (48% of 800,000)	Dfl.	384,000

Exemption:

$$\frac{\text{Dfl. } 100{,}000}{\text{Dfl. } 800{,}000} \times \text{Dfl. } 384{,}000 = \text{Dfl. } 48{,}000$$

Final tax liability: = Dfl. 336,000

If the foreign source income had not been taken into account, the final tax liability would have been the same as a result of the fixed corporate tax rate: 48% of 700,000 = Dfl. 336,000. Moreover, while profits of a foreign branch are not subject to tax in the Netherlands, foreign losses are fully deductible from domestic profits. If any loss remains, it may be carried forward for six fiscal years, and set off against future foreign profits.

b. Rules for exports through subsidiaries.

Income of a foreign subsidiary is not subject to Dutch income tax. The Netherlands has no such provisions comparable to Subpart F of the U.S. Internal Revenue Code. The establishment of a sales subsidiary in a tax haven country is therefore not penalized. Dividends remitted to a Dutch company which is not an investment company are not taxable in the Netherlands provided that (i) the parent owns at least 5 percent of the issued capital of the foreign affiliate, (ii) that the equity participation is within the scope of the business activity of the parent and of the subsidiary, and (iii) that the foreign subsidiary is subject to foreign income tax.

Where dividends are taxable, foreign taxes withheld at source can be deducted from taxable income. Most Dutch tax treaties, however, provide for a direct foreign tax credit, in which case dividend income is reported as gross income.

2. Enforcement of intercompany pricing rules.

In general, the Netherlands tax authorities attempt to enforce the reallocation of income rules. However, Dutch companies may make an agreement on income allocation with the Tax Administration to cover a several year period and these agreements can be very favorable to the taxpayer.

There are no statutory rules against the allocation of profits between the head office and its foreign branch. The tax authorities have the power to require proper reallocation, although substantial discounts made to the branch by the head office may be possible provided they are made on an arm's length basis.

3. Specific tax incentives indirectly benefiting exports.

As a general rule, foreign source interest and royalties are subject to taxation in the Netherlands. However, many tax treaties concluded by the Netherlands provide for relief for foreign withholding taxes paid abroad. The Netherlands does allow special double taxation relief with respect to interest and royalties paid by residents in certain non-treaty developing countries. It is required that interest and royalties be subject to a tax on profit in the source country and that it be actually levied.

Also, a few tax incentives are granted for the purpose of economic development such as accelerated depreciation. Throughout the country (except in the provinces of Utrecht, South Holland and the main part of North Holland), one-half of the acquisition cost of business premises acquired after April 21, 1975 and before December 31, 1976 may be written down on an accelerated basis. The maximum rate allowed is 25 percent per annum and the depreciation must be spread equally over a period of two years.

In addition, an investment credit is available from 8 percent to 16 percent of the cost of certain capital assets to be spread equally over a period of two years.

II. Nontax Incentives.

1. Specific nontax incentives benefiting exports

a. Customs duties.

No import duties are due on goods which are temporarily imported into the Netherlands for repairing, processing or assembling and reexported thereafter. Similarly, no duties are due where goods are temporarily exported for repairing, processing, assembling and reimported within one year after the exportation. Duties are levied only on the incremental value of the goods imported.

b. Export financing.

Commercial paper obtained in export transactions can be discounted or pledged at favorable rates at commercial banks, under the guarantee of the Central Bank. Moreover, the Export Financing Company partly finances medium and long-term export credit, at rates usually below the market rate (usually 9.5%).

c. Credit insurance.

Almost all risks in connection with export transactions may be insured with a special credit private institution which has special arrangements with the government. Coverage is generally 75 percent, but a maximum of 100 percent is possible. Exchange rate fluctuation risks may be covered up to 95 percent.

2. Specific nontax incentives indirectly benefiting exports.

Aid to economic development is granted also by way of nontax advantages. Such incentives, however, do have a favorable effect on export trade activities as well, to the extent that over one-half of the gross national product is currently exported.

a. Investment premiums.

In the development areas, a subsidy of 25 percent of the aggregate investments in fixed assets (lands, buildings, machinery) may be granted. The subsidy cannot exceed approximately $1.1 million (Dfl. 3,000,000) and some requirements must be met such as:

- a minimum investment of approximately $150,000 (Dfl. 400,000).
- equity (capital plus reserves) after investment less premiums amount to at least 40 percent of the total invested capital.

The premium may, at the election of the enterprise, be paid in a lump sum or in five installments.

b. Investment premiums for extension of industrial enterprises.

Extensions of industrial enterprises, located in certain stimulation areas, are eligible for a premium composed of two parts: a lump sum of 15 percent of the cost of investment in tangible capital assets and an amount of approximately $2,000 (Dfl. 5,000) for each additional permanent job created. The aggregate premium cannot exceed the lesser of either 25 percent of the cost of investment or $1.1 million (Dfl. 3,000,000). The principal condition for the grant of extension premiums is substantially identical to that for investment premiums.

c. Interest subsidies for the establishment of new industrial enterprises.

Interest subsidies may be granted in connection with projects of exceptional importance for the strengthening of the industrial structure of the southern and northern development areas. The maximum subsidy is 3 percent over a period of not more than 15 years and may be available for medium-term and long-term capital loans from commercial banks. Although formally still in existence, the interest subsidy has never been granted in practice.

E. JAPAN

I. Tax Incentive.

1. Taxation of foreign source income.

Japanese companies are taxed on a worldwide basis under rules which are much similar to those in effect in the United States. Such tax system will not therefore, be described in detail but only the relevant variances from the U.S. tax system will be mentioned.

a. Japanese tax law has no provision comparable to Subpart F of the U.S. Internal Revenue Code.

b. The allowable foreign tax credit is computed on the overall basis. For purposes of computing the limitation, any loss incurred by a foreign branch need not reduce other foreign source income. This provision is referred to as the "modified" overall limitation and is available upon application to the tax authorities.

c. Japan imposes an excise tax (so-called "commodity tax") on manufacturers, importers or retailers on the sale of 17 types of commodities. Food, medicines and other essential consumer goods and food products are outside the scope of the tax. The tax ranges from 5 percent (for beverages and motor vehicles with two or three wheels) to

30 percent (mainly for luxury items). Commodities exported are exempt from the tax. If the product is exported after being taxed, the tax is repaid and there are special provisions authorizing an exemption or repayment for component parts of exported products. Imports are taxed at the same rate as similar goods on the home markets.

2. Tax incentives directly benefiting exports.

Like any other country in Europe, Japan has been somewhat concerned about encouraging exports. Because its basic tax structure does not allow such effect, it has traditionally provided for direct export tax incentives.

a. Reserve for overseas market development.

Corporations deriving income from overseas transactions are entitled to deduct limited amounts credited to a reserve for overseas market development. These transactions include export of goods, sale of goods to an exporter and processing of goods to be exported, provided payment is in foreign currency. The deductions may go from 1.0 percent to 1.7 percent of the export value of goods purchased from others, depending on the amount of the corporation's capital and may go from 1.5 percent to 2.3 percent for all other overseas transactions. One-fifth of the amount credited to the reserve must be returned each year to income in the five years immediately following the creditation.

b. Deduction of overseas investment losses.

Corporations acquiring and holding 10 percent or more of particular shares of a "Specified Overseas Enterprise Juridical Person", or 1 percent or more of particular shares of a "Specified Investment Juridical Person", can deduct amounts credited to a reserve for losses from such investments up to a specified ratio of the acquisition cost of the shares. A "Specified Overseas Enterprise Juridical Person" is a corporation or other legal entity whose head office is located outside Japan for purposes other than avoidance of taxes and which conducts any kind of business except the investment business. A "Specified Overseas Investment Juridical Person" is a domestic corporation that mainly invests in, or makes long term loans to, a specified overseas enterprise juridical person. These juridical persons are specified where their head office is located in a specified statutory geographical area, mainly developing areas or where they deal with such juridical persons.

Amounts deducted must be added back to taxable income over a five-year period commencing five years after the current taxable year of the deduction.

c. Foreign exchange losses.

A domestic corporation can establish a deductible reserve for foreign exchange losses on its net long term receivables. Amounts deducted must be added back to taxable income in the next accounting period.

d. Entertainment expenses related to export activities.

There is generally a severe limitation on the deductibility of entertainment expenses for tax purposes in Japan. Ordinarily a deduction is limited to about $13,333 per corporation plus 1/4 of 1 percent of capital. The deduction for entertainment expenses in excess of this is limited to 25 percent of the expenditure. However, until 1971, a reasonable amount of overseas and/or domestic travel and hotel expenses in Japan paid for nonresident visitors and entertainment expenses incurred abroad in connection with export transactions were not treated as entertainment expenses for purposes of determining the deductible amount of entertainment expenses, and were fully deductible for corporate income tax purposes.

e. Export allowance.

Domestic corporations are allowed substantial special deductions for certain overseas transactions in an accounting period beginning on or before March 31, 1976. The deduction is the lesser of an amount computed by applying a percentage to proceeds or to net income. The eligible transactions are as follows, provided payment is in a foreign currency:

--Sales or licensing of industrial property rights and the furnishing of technical knowledge such as know-how. The amounts deductible are 70 percent of the proceeds from the transaction limited to 50 percent of the total ordinary income.

--Sales of copyrights. The amounts deductible are 30 percent of the proceeds from the transactions also with a 50 percent limit.

--Consulting or rendering technical services such as research and planning with respect to the manufacture or construction of production facilities, or technical guidance regarding agriculture and fishing. The amounts deductible are 20 percent of the proceeds from the transaction also with a 50 percent limit.

f. Accelerated depreciation in case of export sales.

In 1961, Japan enacted a law to provide for accelerated depreciation in case of export sales. This provision was repealed in 1972 because its objectives were no longer viable in that, while it was originally enacted as a means of stimulating exports by providing tax relief,

27-039 O - 78 - 13

beginning in 1969 Japan started experiencing an unfavorable international balance of payments because of greatly increasing exports.

Under this law, a corporation was allowed a tax deduction for accelerated depreciation based on export sales made in the immediately preceding year. The amount of additional depreciation was computed by applying the ratio of export sales over total sales to maximum ordinary depreciation available. In other words, if export sales were 30 percent of total sales, ordinary depreciation was increased by 24 percent. Ordinary depreciation was at generous rates in the first place. Additional increases in depreciation could be allowed depending on the incremental amount of export sales in each year.

II. Nontax Incentives.

1. Export financing.

a. Japanese suppliers can receive medium and long term credits from the Export-Import Bank of Japan, a government related agency. Generally, medium term sales are supported by means of direct loans at preferential rates of interest. Medium term credits are not supported in Japan.

b. Long term credits are available from Eximbank both on a buyer and supplier basis. Long term credits are those credits exceeding five years. Eximbank usually supports 48 to 64 percent of the contract value and the rates charged as of December 1974 ranged from 7.75 to 8.75 percent. These rates include all types of financing charges but not insurance cost.

2. Export insurance.

a. Export insurance is granted in Japan by the Export Insurance Division/Ministry of International Trade and Industry (MITI). MITI offers export bill insurance to Japanese foreign exchange banks that have purchased eligible debt obligations from exporters. This Japanese Bank guarantee is available for consumer goods exports only.

b. Moreover, a variety or risks are covered such as insolvency of the buyer, protracted default, currency inconvertibility, exchange rate fluctuations, loss of foreign investment, and political risks. Commercial risks are usually covered from 60 to 80 percent while political risks are usually 90 percent covered.

F. UNITED KINGDOM

I. Tax Incentives.

1. Taxation of foreign source income.

a. Rules for direct exports.

A British corporation is taxed on its worldwide income provided it is a resident company. Residency is determined in accordance with the place of management and control and not the place of legal incorporation. Because such a system could give way to substantial tax evasion by exporting the control of a U.K. corporation into a foreign country, a resident corporation must apply for permission to move its corporate residence outside the U.K., and it is usually difficult to obtain such consent. But the fact remains that a number of U.K. companies are not subject to U.K. taxes because they are fully managed and controlled from outside the U.K.

A British resident corporation is taxed on income derived from foreign establishments whether or not the profits are remitted to the U.K. head office. However, foreign tax credit provisions cause no U.K. corporation tax to be payable on foreign source income as long as the rate of taxes paid abroad is below or equals the U.K. tax rate on that same type of income.

The effectiveness of this double tax relief provision was somewhat reduced by the enactment in 1972 of the "Advance Corporation Tax" which became effective from April 1, 1973. The general rule is that where a company makes a qualifying distribution to its shareholders, the company becomes liable for a tax payment equal to 35/65 of the sum distributed. The ACT is then deductible from the corporation tax liability of the company on its profits for that accounting period (termed "mainstream corporation tax"). The new system was mainly introduced for purpose of administrative simplification and avoidance of corporate income double taxation. However, the liability for ACT is not reduced by the foreign tax credit. That limits the foreign tax credit to the corporate tax liability in excess of the ACT. As a consequence, a portion of the foreign tax credit may be disallowed if dividends are paid out of foreign source income, and this is a substantial disadvantage for U.K. companies deriving most of their income from foreign operations. Some relief has been allowed, however, by way of the so-called "overspill relief" which was extended until 1976. Moreover, any company may exercise the option so as to set off ACT against liability to mainstream corporation tax on domestic income before overseas income and against liability to mainstream corporation tax on overseas income taxed on lower rates before higher rates.

b. Rules for export through a foreign subsidiary.

Income of a nonresident corporation is not taxable in the U.K. Moreover, there are no provisions in U.K. tax law comparable to subpart F of the U.S. Internal Revenue Code. Foreign source dividends are taxable to the U.K. parent company, but the resident company is allowed a deemed paid foreign tax credit, whose terms are more favorable than its U.S. counterpart. The deemed paid tax credit is allowed to companies receiving dividends from foreign firms that are at least 10% controlled, directly or indirectly. However, the indirect credit is permitted for holdings of less than 10% where there has been a reduction after 1972 for reasons that could not be prevented. It appears that the taxpayer can designate the period of profits out of which a dividend is paid and thereby affect the amount of creditable taxes. A per-country limitation applies to the foreign tax credit but such limitation can be moderated or avoided in a number of ways.

2. Enforcement of intercompany pricing rules.

To the extent that income of a nonresident company is not taxed in the U.K. until distributed by way of dividends even though use is made of tax haven countries, the tax advantages of establishing a foreign based sales company depends upon how the intercompany pricing rules are enforced.

The experience so far has been that it is unusual for adjustments to be proposed by the tax authorities. One of the reasons might be that such adjustments are generally unnecessary for the companies that are usually most subject to enforcement. As already mentioned, the incorporation abroad of an export trade requires the Administration's authorization. When a tax haven is involved, the U.K. company might have to give assurances that prices will be at arm's length in order to obtain the authorizations. Therefore, very few adjustments are probably required in such a situation.

A second reason is also that such adjustments are generally settled rather than litigated. And the experience has proved that a U.K. company may show that the activities of a foreign sales subsidiary will increase exports from the United Kingdom. Such assertions are known to have considerable influence on the attitude of the authorities toward low prices for exports to selected companies.

3. Specific tax incentives indirectly benefiting exports.

The United Kingdom allows only one minor direct export tax incentive, namely the deduction of business entertainment expenses for corporation tax purposes, but only if the customer entertained resides overseas and is carrying on a trade or business. On the other hand, highly favorable rates of depreciation are granted in connection with a general program of stimulating capital formation.

Investment incentives include the privilege of writing off in one year the whole cost incurred for plant, machinery and equipment. This is known as the "first year allowance". If the first year allowance is only partly used, a high annual depreciation rate (25%) is allowed on the same items. Since 1974, the initial depreciation rate on the construction of industrial buildings has been 50% of the cost thereof (it was 40% before 1974), with an annual writing down of 4 percent.

II. Nontax Incentives.

1. Export nontax incentives.

a. Export financing.

Support to export financing is available through the Export Credits Guarantee Department (ECGD). The ECGD does not extend export credits directly. British clearing banks provide such credits in exchange for ECGD unconditional repayment guarantees, interest rate subsidies and limited portfolio refinancing. The support applies to both medium and long-term credits both on a supplier and buyer basis. Through its guarantee and interest rate subsidies, the ECGD supports from 80 to 100 percent of long-term contract value. The average rate charged borrowers for long-term export credit is approximately 7.8% including finance charges but not insurance costs.

b. Export credit insurance.

Export credit insurance is available through the same agency, ECGD. It covers both commercial currency fluctuations and political risks. The percentage of debt normally insured is 90 for buyer risks and 90 or 95 for political and economic risks. ECGD has very recently introduced a still unique type of insurance, mainly the coverage of risks due to inflation.

Inflation risks are covered for capital goods contracts with an individual value of £2 million or more with manufacturing periods of two years or more. The exporters or buyers are required to bear the first 10% of cost increase and thereafter the ECGD will cover 90% of the next 15% of annual cost increase on a cash contract and 85% of the next 10% of cost increase on a credit contract. The premium charged is 1% per annum of manufacturing period on the eligible value. The program is due to end early in 1977 but will be reviewed in the light of the circumstances then prevailing. It is available for exports to any country except to the EEC countries.

Also where foreign buyers insist on performance bonds, the ECGD usually makes its support available, applying normal standards of underwriting judgment where bonds cannot otherwise be raised. The contracts must be cash or near cash contracts with a minimum U.K. content value of £20 million.

c. Technical assistance to exporters.

There are a large number of subsidized services available to exporters through the Department of Trade and Industry (DTI). DTI arranges for the collective participation of British exporters to trade fairs and exhibitions, provides for information and advertising and works out programs intended to promote British goods.

2. Nontax incentives indirectly benefiting exports.

a. Regional development.

In connection with a program of industrial and regional development, the British Government makes available a number of cash grants, the amount and terms of which depend upon the designated assisted area.

Special development area.

Regional development grants of 22 percent are available towards the cost of capital expenditures on certain new plant and machinery and on industrial buildings. These grants are not deductible in calculating the value of expenditures for the purpose of taxation allowances.

Factories built by the Department of Trade and Industry may be leased at favorable rentals, in some cases with an initial rent-free period. Loans on favorable terms may be made available in selected cases where additional employment is provided, an alternative being interest subsidies granted on commercial loans.

Removal grants may be obtained for up to 80% of certain costs involved in moving an undertaking into one of the assisted areas.

Assistance can be obtained from the Department of Employment toward the cost of training additional labor and of transforming workers in connection with establishing new enterprises.

Employers receive regional employment premiums at the weekly rate of £3 per male worker and £1.50 per female worker.

- Development areas.

The regional grants are payable at the rate of 20%. Factory rentals, loans, interest subsidies, removal and training grants and regional employment premiums are the same as for Special Development Areas.

- Intermediate areas.

Regional buildings grants are available at 20 percent on the cost of industrial buildings. There is no regional grant on purchases of plant and machinery. Other incentives are similar to those mentioned above, except that employers do not receive regional employment premiums.

b. Industrial development.

Under the Industry Act 1972 as amended by the Industry Act 1975, government assistance is available on certain new investments which meet the following conditions:

-- It must be a new investment or modernization the capital cost and working capital of which exceed £500,000.

-- It must be a net addition to the company's capital investment, i.e., it would not take place or would be deferred but for government assistance.

-- The project must be commercially sound and lead to improvements in the balance of payments.

-- The construction work on the project must commence before 30 September 1976.

The government support will be the minimum considered necessary and will consist of loans at concessionary rates of interest but in appropriate cases could be interest free. The support could also be in the form of an interest relief grant.

In order to encourage employers to retain employees who would otherwise be made redundant a temporary employment subsidy may be paid. The subsidy is £10 per week for each deferred redundancy of full time workers and is applicable where redundancies affect 50 or more workers.

APPENDIX C

COMPARATIVE EFFECTS OF DISC AND FOREIGN SAFE-HAVEN TAX INCENTIVES ON PROFIT AND PRICE OF AN EXPORT SALE

EFFECT OF BELGIAN TAX RULES ON PROFIT AND PRICE OF AN EXPORT SALE MADE THROUGH A SUBSIDIARY IN A LOW-TAX COUNTRY

	Sale to Unrelated Domestic Customer	Export Sale Through Trading Subsidiary in Low-Tax Country: Increased Profit At Same Price to Customer		Export Sale Through Trading Subsidiary in Low-Tax Country: Profit Maintained Despite Lower Price to Customer	
Sale By Belgian Company	$10,000	$9,000		$9,000	
Cost of Goods Sold	7,500	7,500		7,500	
Gross Profit	2,500	1,500		1,500	
Selling & Administration Expense	500	500		500	
Profit Before Tax	2,000	1,000		1,000	
Sale by Trading Subsidiary			10,000		9,670 ($330 reduction)
Cost of Goods Sold			9,000		9,000
Gross Profit			1,000		670
Selling & Admin. Expense of Trading Subsidiary			100		100
Profit Before Tax			900		570
Tax on Subsidiary			90		57
Profit After Tax			810		513
Dividend To Parent		810		513	
Add 5% Gross-up 1/	-	41		26	
Taxable Income Before Exclusion	2,000	1,851		1,539	
Less: Excludable Portion of Dividend (95%)	-	799		512	
Taxable Income	2,000	1,052		1,027	
Tax	960	505		493	
Less: Tax Credit (5%) 2/	-	41		26	
Net Tax	960	464		467	
Profit After Tax (Parent's Income Before Tax, Plus Subsidiary's Net Income After Tax, Less Parent's Tax)	$ 1,040	$1,346		$1,046	

1/ Under Belgian law, the amount of any dividend received from the subsidiary must be increased by a "gross-up" of 5% in computing taxable income.

2/ This credit offsets the "gross-up" described in footnote 1.

EFFECT OF FRENCH TAX RULES ON PROFIT AND PRICE OF AN EXPORT SALE MADE THROUGH A SUBSIDIARY IN A LOW-TAX COUNTRY

	Sale to Unrelated Domestic Customer	Export Sale Through Trading Subsidiary in Low-Tax Country: Increased Profit At Same Price to Customer		Export Sale Through Trading Subsidiary in Low-Tax Country: Profit Maintained Despite Lower Price to Customer	
Sale By French Company	$10,000	$9,000		$9,000	
Cost of Goods Sold	7,500	7,500		7,500	
Gross Profit	2,500	1,500		1,500	
Selling & Administration Expenses	500	500		500	
Profit Before Tax	2,000	1,000		1,000	
Sale by Trading Subsidiary			10,000		9,700 ($300 reduction)
Cost of Goods Sold			9,000		9,000
Gross Profit			1,000		700
Selling & Admin. Expense of Trading Subsidiary			100		100
Profit Before Tax			900		600
Tax on Subsidiary			90		60
Profit After Tax			810		540
Dividend to Parent		810		540	
Less 95% Exclusion		770		513	
Net Dividend		40		27	
Add 50% Gross-up 1/		20		14	
Taxable Dividend		60		41	
Taxable Income	2,000	1,060		1,041	
Tax (50% rate)	1,000	530		521	
Parent's Profit Before Tax	2,000	1,000		1,000	
Subsidiary's Profit After Tax	---	810		540	
	2,000	1,810		1,540	
Less: Parent's Tax	1,000	530		521	
Net Profit	$ 1,000	$1,280		$1,019	

1/ Under French law, the amount of any dividend received from the subsidiary must be increased by a "gross-up" of 50% in computing taxable income.

EFFECT OF THE NETHERLANDS TAX RULES ON PROFIT AND PRICE OF AN EXPORT SALE
MADE THROUGH A SUBSIDIARY IN A LOW-TAX COUNTRY

	Sale to Unrelated Domestic Customer	Export Sale Through Trading Subsidiary in Low-Tax Country: Increased Profit At Same Price to Customer		Profit Maintained Despite Lower Price to Customer	
Sale By Dutch Country	$10,000	$9,000		$9,000	
Cost of Goods Sold	7,500	7,500		7,500	
Gross Profit	2,500	1,500		1,500	
Selling & Administration Expense	500	500		500	
Profit Before Tax	2,000	1,000		1,000	
Sale By Trading Subsidiary			10,000		9,680 ($320 reduction)
Cost of Goods Sold			9,000		9,000
Gross Profit			1,000		680
Selling & Admin. Expense of Trade Subsidiary			100		100
Profit Before Tax			900		580
Tax on Subsidiary			90		58
Profit After Tax			810		522
Dividend To Parent		810		522	
Less: 100% Exclusion		810		522	
Taxable Income	2,000	1,000		1,000	
Tax (48% rate)	960	480		480	
Parent's Profit Before Tax	2,000	1,000		1,000	
Subsidiary's Profit After Tax	-	810		522	
	2,000	1,810		1,522	
Less Parent's Tax	960	480		480	
Net Profit	$ 1,040	$1,330		$1,042	

-C3-

EFFECT OF BRAZILIAN TAX RULES ON PROFIT AND PRICE OF AN EXPORT SALE MADE THROUGH A BRANCH IN A LOW-TAX COUNTRY

	Sale to Unrelated Domestic Customer	Export Sale Through Trading Subsidiary in Low-Tax Country: Increased Profit At Same Price to Customer		Export Sale Through Trading Subsidiary in Low-Tax Country: Profit Maintained Despite Lower Price to Customer	
Sale by Brazilian Company	$10,000	$9,000		$9,000	
Costs of Goods Sold	7,500	7,500		7,500	
Gross Profit	2,500	1,500		1,500	
Selling & Administration Expense	500	500		500	
Profit Before Tax	2,000	1,000		1,000	
Sale by Foreign Branch			$10,000		$9,777 ($223 reduction)
Cost of Goods Sold			9,000		9,000
Gross Profit			1,000		777
Selling & Admin. Expenses of Trading Branch			100		77
Profit Before Tax			900		700
Tax on Branch			---		---
Profit After Tax			900		700
Parent's Tax	600	300		300	
Profit After Tax	1,400	700		700	
Add: Nontaxable Branch Income	---	900		700	
Total Profit After Tax	$ 1,400	$1,600		$1,400	

EFFECT OF SPANISH TAX RULES ON PROFIT AND PRICE OF AN EXPORT SALE
MADE THROUGH A SUBSIDIARY IN A LOW-TAX COUNTRY

	Sale to Unrelated Domestic Customer	Export Sale Through Trading Subsidiary in Low-Tax Country			
		Increased Profit At Same Price to Customer		Profit Maintained Despite Lower Price to Customer	
Sale By Spanish Company	$10,000	$9,000		$9,000	
Cost of Goods Sold	7,500	7,500		7,500	
Gross Profit	2,500	1,500		1,500	
Selling & Administration Expense	500	500		500	
Profit Before Tax	2,000	1,000		1,000	
Sale by Trading Subsidiary			$10,000		$9,910 ($90 reduction)
Cost of Goods Sold			9,000		9,000
Gross Profit			1,000		910
Selling & Admin. Expense of Trading Subsidiary			100		100
Profit Before Tax			900		810
Tax on Subsidiary			90		81
Profit After Tax			810		729
Dividend to Parent		810		729	
Taxable Income Before Exclusion	2,000	1,810		1,729	
Less: Excludable Portion of Dividend (33%)	---	267		241	
Taxable Income	2,000	1,543		1,488	
Tax (at 36%)	720	555		536	
Less: Foreign Tax Credit	---	90		81	
Net Tax	720	465		455	
Profit After Tax (Parent's Income Before Tax, Plus Subsidiary's Net Income After Tax, Less Parent's Tax)	$ 1,280	$1,345		$1,274	

EFFECT OF IRELAND'S EXPORT TAX EXEMPTION ON
PROFIT AND PRICE OF AN EXPORT SALE

	Sale to Unrelated Domestic Customer	Export Sale	
		Increased Profit at Same Price to Customer	Profit Maintained Despite Lower Price to Customer
Sale by Irish Company	$10,000	$10,000	$9,000 ($1,000 reduction)
Cost of Goods Sold	7,500	7,500	7,500
	2,500	2,500	1,500
Selling & Administration Expenses	500	500	500
Profit Before Tax	2,000	2,000	1,000
Tax at 50%	1,000	---	---
Profit After Tax	$ 1,000	$2,000	$1,000

EFFECT OF DISC ON PROFITS OF A U.S. EXPORTER

	Sale to Unrelated Domestic Customer	Export Sale Through a DISC	
		Parent	DISC
Selling Price	$ 10,000	$ 10,000	
Cost of Goods Sold	7,500	7,500	
Gross Profit	2,500	2,500	
Selling & Admin. Expense	500	500	
Profit Before Tax	2,000	2,000	
Commission Paid to DISC			$1,000
Deemed Dividend of DISC to Parent		500	500
DISC Income (Deferred)			500
Parent's Taxable Income	2,000	1,500	
Tax on Parent's Income (at 48%)	960	720	
Parent's Net Profit After Tax	1,040	780	
Reserve for Deferred Tax (at 48%)			240
DISC Net Profit After Reserve			260
Total Net Profit After Taxes & Reserves	$ 1,040		$ 1,040

It should be noted that the export sale through the DISC does generate an additional cash flow of $240, the amount of the tax deferral. However,that tax will ultimately have to be paid, so a reserve for the deferred tax has been created to showthat this amount is not to be considered either as additional profit or as being available for a price reduction. Because the DISC rules do not require payment of interest on the deferred tax, it could be considered that the DISC's parent achieves a saving of the 6% interest with the Internal Revenue Service would otherwise levy. In the above example, that saving amounts to $15.60.

APPENDIX D

BACKGROUND ON AND THE CONTROVERSY OVER THE INTERNATIONAL RULES ON EXPORT SUBSIDIES UNDER GATT

I. THE IMPENDING INTERNATIONAL CONFRONTATION OVER EXPORT SUBSIDIES

For more than a decade, the United States has been pressing for greater fairness in the international trade rules governing the use of tax benefits as export subsidies. It has been and continues to be the U.S. position--forcefully stated both by the Congress and by a series of Democratic and Republican Administrations--that existing international rules place American exporters at a severe disadvantage by allowing other nations to grant export incentives far greater than those which the U.S. is able to provide. This anti-U.S. bias under the international rules has two major aspects:

First, despite the fact that, at least in principle, the General Agreement on Tariffs and Trade ("GATT") places severe restrictions on the ability of a nation to use its direct-tax[1/] system to promote exports, the ambiguity and lack of enforcement of the GATT rules have resulted in the proliferation of very substantial direct-tax export subsidy

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1/ There is no clear unanimity as to the precise definitions of "direct" and "indirect" taxes. In general, direct taxes are those borne by an individual or company, while indirect taxes are levied against the product or on a transaction. These definitions create significant ambiguities as to some types of taxes. For example, it is not clear whether a property tax is direct or indirect. However, in practice the application of the terms under GATT has been fairly consistent as to the two major types of taxes considered in this White Paper. Income taxes have been regarded as "direct"; sales, excise, VAT and commodities taxes are "indirect."

systems in most major trading nations. Almost the only exception is the United States, which carefully tailored DISC--its lone tax-related export incentive device--to conform to the GATT rules. As a result, the DISC program, although of significant value to U.S. companies and to the export posture of the United States, is far more limited and less beneficial than the tax-related subsidies provided by other trading nations to their exporters.

Second, while the GATT rules sharply restrict the use of direct taxes to promote exports, they give carte blanche to the remission or rebate of indirect taxes on export transactions. This places the United States at a major disadvantage, because it has made a policy decision to rely principally for its revenue on progressive income taxes rather than regressive indirect taxes. The U.S. position is that any such policy choice, made for legitimate domestic reasons, should not place a nation's exporters at a disadvantage in international trade.

Over the years, the United States' efforts to obtain a revision of the international rules on export subsidies have proved totally unavailing, owing to the consistent refusal of other nations to enter into serious discussions of the subject. The inability of the United States to bring about a negotiated reform of the GATT rules was, in fact, a major reason for the adoption of the DISC legislation in 1971. If the rules could not be made more fair to the United States, then the creation of an export incentive for U.S. firms which would be legal under GATT and which would partially offset the disadvantage of American exporters competing with subsidized foreign firms was justified and reasonable. In keeping with this principal goal, DISC was carefully designed to offer export benefits to U.S. firms in a way which would not violate GATT principles. To avoid infringing the GATT restrictions on "exemptions" and "remissions" of direct taxes, DISC was limited to a partial deferral of tax on income earned from exports.

As a result of the desire to adhere fully to the GATT rules, the DISC export incentive gives U.S. exporters only a fraction of the benefits received by foreign companies from their governments. Where DISC grants only a deferral of tax on income from exports--and only a portion of export income is eligible for such treatment--most foreign exporters can completely avoid payment of tax on substantially all export income. This tax exemption is achieved in various countries by a variety of means, including:

- Outright exemption of export-derived income
- Failure to tax the income of or dividends from sales subsidiaries or divisions in offshore tax-haven countries
- Various tax credits for export-related investments and expenses

In addition to these direct-tax subsidies, foreign exporters routinely benefit from large rebates or remissions of indirect taxes. In the United States, export transactions are also ecxempt from indirect taxes, but the benefit of such exemption is quite limited. The U.S. indirect-tax structure encompasses only state sales taxes at relatively low rates (most are well below 5%, and many states have none at all), together with federal excise taxes on a small group of products. In other countries, by contrast, across-the-board indirect taxes at high rates are a major source of tax revenue. In Japan, the commodities tax rates run as high as 30%, and the maximum value-added tax rates are even higher in some European countries. The remission of these taxes on export sales confers a huge advantage upon foreign exporters, and places U.S. firms at a corresponding disadvantage in international markets. Moreover, some foreign countries use their indirect tax systems to grant additional subsidies, with exporters receiving so-called "tax rebates" which are in fact wholly unrelated to the exporter's liaiblity for domestic indirect taxes.

Despite the fact that DISC provides only a fraction of the benefits received by foreign exporters, the adoption of DISC was greeted by vigorous protests on the part of other trading nations. In 1972, the European Community filed a complaint under GATT alleging that the DISC program constituted a violation of Article XVI:B4, which outlaws the granting of any subsidy on the exportation of a product "which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market."

The United States denied that DISC in any way violated the GATT provisions, and at the same time filed its own complaints against certain income tax practices of France, Belgium and the Netherlands. In each case, the United States complained that the European country did not tax the income of offshore selling branches or subsidiaries in tax-haven countries, failed to tax the dividends paid to the domestic parent company by such a tax-haven affiliate, and allowed companies great flexibility in allocating income between the domestic parent and the tax-haven affiliate. The resulting exemption of export income from domestic taxation is, in virtually every instance, a far greater subsidy than the deferral provided by DISC.

A special GATT Panel was appointed to consider these charges. In November, 1976, the Panel reached preliminary decisions on all four complaints. In each case, the Panel concluded that the export incentive "in some cases had effects which were not in accordance with ... obligations under [GATT]" and "that there was a prima facie case of nullification or impairment of benefits which other parties were entitled to expect under the General Agreement." Of the four cases, the DISC decision obviously posed the greatest difficulties for the Panel, for two major reasons:

First, previous GATT considerations of the issue had never classified the mere deferral of taxes as an export subsidy. Indeed, one GATT panel which dealt specifically with the issue concluded that such deferral was in the "gray area" where there was no international consensus as to whether it was a subsidy or not.

Second, subsidies violate GATT only when they result in a reduction of export prices below prices charged in comparable domestic transactions. The complaining parties presented no evidence whatsoever that DISC causes such "bi-level pricing."

Despite these difficulties, the Panel found a prima facie case that DISC "in some cases" infringes GATT principles. It reached this conclusion by focusing on the failure to charge interest on taxes deferred under DISC, classifying that minor facet of DISC as a tax "exemption," and engaging in a rebuttable presumption that DISC results in bi-level pricing. The U.S. representatives argued vigorously against the Panel's conclusion as to DISC, but their arguments were rejected.

The United States has asked that the four Panel reports be taken up by the GATT Council. This could lead to further proceedings in which U.S. representatives would have an opportunity to contest the Panel's conclusion on DISC and rebut the presumptions on which that conclusion was based, and at the same time continue to press our complaint against the tax practices of the three European nations. The U.S. has also urged that acceptance of the four Panel reports be made the basis for a general international renegotiation of the rules on use of tax devices to promote exports.

In contrast to the American position, the European Community refuses adamantly to permit any GATT consideration of the Panel reports on Belgium, France and the Netherlands. Instead, it urged the Council to consider only the DISC report, to order the U.S. either to abandon DISC or to give compensation to other countries, and to ignore entirely the companion Panel reports relating to the much greater European subsidies.

A major reason for the European Community's intransigent position is its belief that the United States will unilaterally abolish DISC. The European governments hope that, by maintaining a deadlock in GATT until the U.S. takes unilateral action to rescind DISC, they can achieve their goal without having to abandon or modify any of their own subsidies.

A similar intransigence has characterized the positions of the major trading nations in Europe and Japan with respect to the use of indirect tax rebates or remissions to subsidize exports. For more than a decade, U.S.

negotiators have argued that the GATT distinction between direct and indirect taxes discriminates unfairly against the United States. The overwhelming majority of economists agree that there is no economic basis for that distinction. Nevertheless, representatives of Japan and the European nations have steadfastly refused to give serious consideration to any change in the present GATT rules.

Just as in the field of direct-tax subsidies, however, developments are rapidly moving the indirect-tax subsidy issue toward a critical juncture. In two court cases, major U.S. industries are asking that countervailing duties be imposed on imports which benefit from remission of the Japanese commodities tax and the European value-added tax. In the Japanese case, the Zenith Radio Corporation is challenging imports of consumer electronic products which receive commodities tax rebates ranging from 5 to 20 percent. In the other case, United States Steel Corporation is asking that duties be imposed to offset VAT remissions ranging from 8 percent to 20 percent on steel exports from the seven Common Market countries.

The value of the steel and electronic product imports involved in these cases runs into billions of dollars, but the significance of the cases goes far beyond these specific imports. Almost all consumer products exported from Japan benefit from commodities tax rebates. Automobiles, for example, receive rebates of 30 percent.

And in the Common Market, substantially _all_ exports of any nature whatsoever benefit from VAT rebate or remission. Moreover, the domestic legal issue upon which these cases turn--whether an indirect-tax rebate is a subsidy against which countervailing duties should be imposed--goes to the heart of the GATT distinction between direct and indirect taxes, the very distinction against which the United States has protested in international negotiations for more than a decade.

It seems clear that the issues raised by the _Zenith_ and _U.S. Steel_ cases will be taken to the United States Supreme Court. On April 12 of this year, a three-judge Customs Court panel unanimously ruled in the _Zenith_ case that countervailing duties should be imposed to offset the rebate of the Japanese commodities tax. On July 28, the Court of Customs and Patent Appeals reversed by a vote of 3 to 2. _Zenith_ has announced its intention to appeal to the Supreme Court. _U.S. Steel_ has also confirmed that it will take its case to the highest appellate tribunal, if necessary.

Despite the pendency of the two lawsuits, neither Japan nor the European Community has yet shown any willingness to compromise or even to discuss a revision of the GATT rules. Immediately after the initial _Zenith_ decision, the Government of Japan submitted an official protest to the United States. More recently, a special GATT Panel issued a report contending that the _Zenith_ decision constituted a violation of the GATT rules and that action taken by the United States under the countervailing duties law pursuant to that decision would warrant retaliation by affected GATT members.[2/] That report was immediately endorsed in strong terms by the GATT Council. For the present, Japan and the European Community have adopted the strategy of putting maximum pressure on the U.S. Government to refrain from imposing countervailing duties, while continuing at the same time to maintain their position that the GATT rules on indirect-tax export subsidies are non-negotiable.

The effect of the two countervailing duty cases has been to draw unprecedented attention to the fact that foreign exporters receive a tremendous advantage from their governments in the form of indirect-tax rebates. Although the U.S. government is resisting the imposition of countervailing duties, it has publicly conceded the economic merit of the plaintiff's cases. The continued publicity which these cases are receiving creates increasing U.S. public and Congressional pressure which will make it significantly more difficult for Europe and Japan to maintain their present position of categorically refusing to allow any reconsideration of the GATT direct-indirect dichotomy. That pressure could

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2/ In this regard, it should be noted that the Customs Court specifically considered the relationship between the United States Countervailing Duties Law and the GATT rules, and concluded that the U.S. law--which predates GATT by more than 50 years--must prevail over the GATT provisions in any case of conflict between the two.

become overwhelming if the courts ultimately order the imposition of countervailing duties. To fail to permit a renegotiation of the rules at that point would risk imposition of U.S. countervailing duties on substantially all imports from the European Community and on the great majority of Japanese imports. On the other hand, if duties are not imposed, domestic pressure for a forceful U.S. negotiating effort will intensify, because it will become even more clear to Congress and to the American public that a revision of the international rules offers the only prospect of a solution to this serious trade problem.

This controversy over export subsidy rules may appear at first glance to be rather esoteric, with highly technical arguments on each side of the issue. The stakes, however, are very high and the significance to American trade policy is very substantial. As this White Paper will show, the present international subsidy rules place U.S. exporters at an acute disadvantage in competing with heavily-subsidized foreign firms in world markets. The direct-tax benefits received by such foreign companies are very great indeed, and permit those companies either to increase their profits substantially on export sales or to reduce export prices significantly. Moreover, rebates or remissions of indirect taxes allow foreign firms'

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products to be sold at export prices which are sometimes more than 30 percent lower than the prices paid by domestic customers.

For more than a decade, the United States has sought to negotiate a revision of the export subsidy rules which would eliminate this inequity. To date, those efforts have been totally unsuccessful, owing to the absolute refusal of our trading partners to consider any revision. Their position has been and continues to be that their forms of export stimulation are entirely legitimate while the lone U.S. export incentive--DISC--violates the international rules and must be abolished.

Now, however, rapidly developing events are creating a situation where meaningful negotiations may have to take place. It is the conclusion of this White Paper that U.S. prospects for success in such negotiations will depend in large part upon the U.S.'s willingness to maintain a strong negotiating posture. From this standpoint, the DISC issue is of major importance. If the United States were unilaterally to abolish or weaken the DISC program, without corresponding action on the part of Europe and Japan to eliminate or reduce their much larger export subsidies, the prospects for success in such negotiations would be greatly reduced. Moreover, abandonment of DISC at a time when our major competitors in world trade continue to bestow large export subsidies would seriously weaken the competitiveness of U.S. exports and aggravate our already-deteriorating balance of trade. Accordingly, it is the strong recommendation of this White Paper that DISC be retained as an important element of U.S. international trade policy.

II. THE DEVELOPMENT OF THE INTERNATIONAL RULES GOVERNING EXPORT SUBSIDIES

A. Background - The Adoption of the GATT Rules

The root causes of the present controversy over tax-related export subsidies can be traced directly to the original GATT rules adopted in 1947. In many respects, those rules are today wholly unrealistic in their application to modern international trade issues. To some degree, this is attributable to the adoption by GATT of now-outmoded economic theories, some of which reflect the thinking of Adam Smith and the trading practices of the 18th and 19th centuries rather than the ideas and conditions of the mid-20th century world. In addition the inadequacy of the rules reflects the initial and continuing lack of agreement among the contracting nations on specific or even general regulatory principles in many areas.

The use of tax systems to promote exports is a clear example of a subject with which the drafters of the General Agreement simply did not deal effectively or meaningfully. Unwilling to abandon or limit their abilities to promote exports in whatever manner they saw fit, the initial Contracting Parties could agree only on very limited and highly ambiguous precepts regarding export subsidies.

It should be emphasized at the outset that the world trade environment which existed in 1947 made the issue of export subsidies a matter of secondary importance at best in the drafting of the GATT rules. Most of world trade had moved under comprehensive government controls for nearly two decades. Tax measures and other subsidy devices were minor in their effects on trade compared to the complex controls over trade, capital, and investment which virtually all nations had established during the 1930's and had tightened during World War II. Moreover, indirect tax rates were generally low compared to current tax rates, and few if any nations had comprehensive consumption-tax schemes blanketing all products traded.

For the United States in particular, the issue of export subsidies was of minor significance. America had emerged from World War II as the dominant economic force in the Free World and was running large trade surpluses. The issue was not how to preserve the U.S. trade position, but how to rehabilitate the economies and trade positions of other countries. As the U.S. delegate put it in a statement to a GATT Working Party in 1968:

> [A]lready existing practices were incorporated without searching examination. The rules [on use of taxes to subsidize exports] were drafted in very general terms. The United States at the time had no pressing reasons for seeking more elaborate provisions which provided more equitable safeguards for its trading position. On the contrary, at that time the United States was conscious of the need to assist other countries in relieving the pressures of the so-called dollar gap and the requirements for post-war reconstruction. Little detailed attention was paid to a problem which might hypothetically arise which would be harmful to our then strong payments position.

The result was that tax practices with significant effects on trade received virtually no attention when the post-war rules which were to govern international trade were first formulated in 1947--rules which are still essentially unchanged three decades later. The record of the initial GATT deliberations, in fact, is devoid of any discussion of the effects of differing tax systems or differing types of taxes upon trade.

Thirty years later, this failure to deal effectively with taxes as export subsidies has become a source of major inequity and serious distortions in the world trading system. The problem has two fundamental aspects:

First, the generality and ambiguity of the rules on export subsidies has permitted nations to devise and use major direct-tax export incentives while still maintaining that such incentives do not constitute "subsidies" which would violate the GATT rules.

Second, the express sanction by the GATT of the rebate or exemption of indirect taxes has created a serious trade bias in favor of countries which rely heavily on such taxes and against countries which, like the United States, have chosen to utilize progressive income taxes to satisfy their revenue needs.

B. The Ambiguity of GATT Treatment of Direct-Tax Subsidies

The proliferation of direct-tax export subsidies which now characterizes world trade is largely attributable to the generality and ambiguity in the GATT treatment of the general issue of export subsidies. The GATT rules did virtually nothing to establish any meaningful framework of restraints over subsidies and their fundamental effects on trade. Neither the initial Articles of the GATT nor its subsequent Notes and Supplementary Provisions to this day clearly define specific practices which constitute subsidies. Nor do they state a clear policy regarding export incentives in general or provide any viable means of recourse against export subsidies short of countervailing duty actions.

The original GATT Article XVI as adopted in 1947 essentially imposed only two constraints upon the use of subsidies, undefined as they were. It stated that nations were obligated to notify and consult on any "subsidies" they maintained. After January 1, 1958, they were also to cease those practices in nonprimary products which resulted in dual pricing. The founders apparently saw no reason or were unwilling to define or specify which types of export-promoting mechanisms might constitute a "subsidy."

The only effort in the subsequent three decades of GATT history to grapple with the subsidy problem was the quixotic contribution of a GATT Working Party set up in the late 1950's to define export subsidies. However, its Report, which was adopted in 1960 and became effective in 1962, did little to disturb the vacuum.

The Working Party offered no broad new definition of subsidies. Despite its mandate, it stated "that it was neither necessary nor feasible to seek an agreed interpretation of what constitutes a subsidy." Rather, it proposed only an "illustrative" but not exhaustive list of measures which, it urged, should "generally be considered as subsidies" in the sense of Article XVI. This list, adopted by some nations and not by others, classified as "subsidies" (among other practices) the "remission" or "exemption" on exports of direct taxes, social welfare charges or any taxes other than indirect taxes. As subsequent events have shown, the terms "remission" and "exemption," viewed in light of the complex export incentive practices in use by major trading nations today, can be as mercurial and difficult to apply as the word "subsidy" itself.

C. The GATT Sanctioning of Indirect-Tax Subsidies

The failure of the GATT rules to place any restrictions on the remission or exemption of indirect taxes on export transactions can be traced to two principal factors, one historical and the other arising from then-current economic theory.

For a hundred years or more prior to the establishment of the GATT, it was common practice in international trade to impose upon imports any excise or consumption tax being levied on domestic products. It was agreed that imported goods should not receive any more favorable treatment than was accorded the like domestic products. This practice was observed, regardless of the form the domestic tax on consumption took, by most countries including the United States. It was also incorporated in pre-1947 U.S. bilateral trade agreements. On the export side, it was also generally agreed that exported products should not be subject to double excise taxation, first at home and again in the country of destination. Moreover, a country with relatively higher indirect domestic taxes, it was argued, should not be disadvantaged in world markets. They were, therefore, frequently exempted or rebated upon export.

The founding GATT fathers also relied implicitly upon the simple assumptions of the then-conventional economic wisdom on shifting and incidence of taxes. Without pausing to define either tax category, they embraced the assumption that indirect taxes were fully reflected in prices and that direct taxes were fully absorbed by the seller with no effect on price. Therefore, they reasoned, it made no difference to the seller whether an indirect tax was or was not charged on a transaction. If the tax was totally and invariably passed on to the customer, the seller's profit would be the same with or without the tax.[3/] Under this reasoning, they found no basis for restricting the rebate or exemption of indirect taxes on export sales. Moreover, they concluded that the appropriate international treatment of such indirect taxes would be to impose them only upon domestic sales, on the theory that the party bearing the burden of an indirect tax on an export sale would be the purchaser in a foreign country, and one country should not impose its indirect taxes upon foreign persons.

3/ Apparently no consideration was given to the fact that, even if the indirect tax _is_ passed on to the buyer by an increase in price, that price increase may reduce demand for the product sold, thus reducing sales volume and profits.

The principle that taxes borne by products would normally be levied only in the country of destination and would not be assessed on exports was embodied in several pre-war U.S. bilateral trade agreements and in the U.S. draft for the Havana Charter. It went on to become part of GATT's "legislative history" and was incorporated into several of the GATT provisions dealing with taxation. Indeed, a primary thrust of the original Articles was to distinguish taxes on products (indirect taxes) from "all other" taxes.

Article III, for example, is wholly concerned with taxes on products and fails to mention taxes on income or profits. In keeping with the inherited economic theory and previous practice, Article III permitted taxes on imports where domestic products bore the same tax. It made no reference, however, to any rebate when the domestic product was exported. Its primary purpose, clearly, was not to deal with taxes as an export-related problem but to prevent domestic taxes from being imposed in a fashion to afford additional protection to a domestic industry beyond that provided by tariffs.

Oddly, the distinction between direct and indirect taxes did not appear in the original version of Article XVI (the subsidies provision) as adopted in 1947--further evidence that the GATT founders failed to focus on the problems and ramifications of using tax systems to promote exports. The principle that a rebate of indirect taxes would not be deemed a "subsidy" was, however, indirectly recognized in Article VI, the GATT antidumping and countervailing duties provision. Section 4 of Article VI specifically exempted indirect-tax rebates or exemptions from the imposition of countervailing or antidumping duties:

> 4. No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to anti-dumping or countervailing duty by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes.

Not until 1957, however, were the GATT rules on export subsidies amended specifically to exempt indirect taxes from the restrictions placed upon the use of tax systems to stimulate exports. In that year, an amendment to Article XVI provided that the exemption or remission of domestic taxes borne by a product destined for export was not to be deemed a "subsidy," thus conforming Article XVI to Articles III and VI and to the underlying tax-shifting assumptions of the GATT.

This amendment, however, did not prohibit other border adjustments of taxes which might be regarded as subsidies. Nor did it take the further logical step of prohibiting border adjustments for other, non-tax practices which might also have the effect of subsidizing exports.

Since 1957, then, a clear distinction has been drawn in the GATT rules. Use of direct taxes to promote exports is subject to limitations (although vagueness of terminology hampers enforcement of the limitations), but carte blanche is given for the remission or exemption of indirect taxes on exports.

III. THE UNITED STATES' EFFORTS TO OBTAIN FAIRNESS IN THE INTERNATIONAL RULES

A. The Increasing Inequity of the Rules

As discussed above, the GATT began its history by largely evading the basic issue of what constitutes a "subsidy," while at the same time making it clear that rebates or remissions at the border for indirect taxes would definitely not be considered subsidies. In the world of 1947--and even 1957--the export subsidy issue was of minor significance and the shortcomings of the GATT rules were not particularly harmful to the United States.

Thirty years later, these deficiencies of the GATT have become sources of major inequity and serious distortion in the world trading system. The result today is a serious bias against, and manifestly unfair treatment of, nations relying heavily upon direct taxes. At the same time, the GATT rules provide no effective recourse against the continuous development of ingenious direct-tax export incentives. In short, the GATT provisions today are heavily biased in favor of countries relying upon so-called indirect taxes and countries where it is politically acceptable to warp domestic fiscal policies to promote exports.

Fundamental changes have occurred in the structure of international trade since the formulation of GATT. The comprehensive wartime controls over the flow of goods, services and finance which were characteristic of most nations in the world of 1947 have since been largely dismantled. Tariffs have also been drastically reduced. The free play of competitive market forces now exerts a far greater role in determining what is exported and what is imported than was remotely possible three decades ago.

Moreover, the basic nature and intensity of world competition itself has changed. Regional blocs and vast economic unions, such as the European Community, with more closely integrated trading and fiscal systems, have come to dominate much of world trade. The major developed nations today all compete on a far more equal footing in economic terms. And trade itself has expanded enormously as tariff barriers were successively lowered and interdependence became a pervasive reality.

On the fiscal side, all nations have persistently sought additional revenue from more sources. Taxes "borne by products," in the words of the GATT, have come to be major sources of new revenues for most nations, with both higher rates and far broader product coverage than existed in 1947. Of equal significance, most major trading countries have come to adopt the value-added version of the consumption tax. The border adjustments permitted under the GATT rules for these types of domestic taxes in many instances have risen to levels exceeding the levels of the remaining tariffs on the same products, often by very substantial margins. Under the GATT rules, adjustments are permitted for these indirect taxes but not for other types of taxes nor, of course, for other types of governmental action affecting trade. In short, the initial GATT rules in a changing world provide increasing advantage for nations relying on indirect taxation and worsening handicaps for those with other philosophies and tax structures.

On the export promotion side, the tides of change were equally strong and their impact on trade has been dramatic. Over the past three decades the export incentive schemes of nations proliferated in many forms and for many reasons. In part, they have been created to replace dismantled tariffs and trade controls with other forms of assistance to domestic industries. In part, nations adopted export incentives and provided subsidies for purely mercantilistic reasons--to improve trade and payment balances and to augment foreign-exchange reserves.

With the vague and general GATT definitions and rules imposing virtually no restraint, export-incentive schemes took many forms. Taxation was but one of these, though a very significant one. A common form of export incentive has been to tax profits from exports more moderately than other profits or, as many countries still do, to levy no direct tax at all on export earnings. The income-tax principle of territoriality, for example, has been widely adopted. Together with use of affiliated or subsidiary companies in tax-haven countries, the result is often little or no tax liability for export earnings. In addition, there has been a proliferation of other forms of direct-tax export subsidies, including special depreciation, deductions and credits for export-related factors.

This export-incentive race over the past three decades was clearly not restrained by GATT rules, nor was it inhibited by any threat of GATT disciplinary action. Such rules as now exist are seldom if ever tested or applied to restrict Member countries. The result has been that new advantages stemming from manipulation of direct taxes have provided much the same trade-distorting effects as those also permitted under the GATT rules for indirect taxes. In short, both direct and indirect taxes have come to be widely employed by major foreign countries to build substantial export subsidies into their national tax structures.

The country most adversely affected by these trends and by the inequities of the GATT rules has been the United States. Unlike other major trading nations, the U.S. has not participated in the export-incentive race in any significant way. With respect to indirect taxes, the United States has been unable to take advantage of the GATT rules because our country has been politically and socially committed to emphasis on progressive income taxes rather than regressive indirect taxes to raise necessary revenues. On the direct-tax side, the U.S. has simply taken its GATT obligations more seriously than many other countries, and has construed the export subsidy rules more strictly and more narrowly. In short, unlike many major trading nations, the United States has not been willing to manipulate its tax system for the purpose of obtaining a trading advantage.

As a consequence, American firms operate at a significant disadvantage when competing with heavily-subsidized foreign exporters in world markets. The extent of that disadvantage is analyzed in Part VII of this White Paper.

B. U.S. Efforts to Negotiate a Revision of the International Rules

The growing use of tax devices by other countries to affect international trade eventually led the United States to seek changes in the basic rules. The principal focus of these U.S. efforts has been the GATT distinction between direct and indirect taxes. For the past decade, it has been the U.S. position in international forums that there is no longer, if there ever was, any logical justification for the distinction between border adjustments for direct and indirect taxes. In particular, our spokesmen have argued that there is no valid economic basis for assuming that one type of tax is not reflected at all in prices while the other is shifted fully into prices.

Accordingly, a major effort was begun in the 1960s to persuade our trading partners to review and revise the international rules on use of taxes to subsidize exports. This undertaking was entirely in keeping with Article XVI itself, Section 5 of which provides:

> 5. The Contracting Parties shall review the operation of the provisions of this Article from time to time with a view to examining its effectiveness, in the light of actual experience, in promoting the objectives of this Agreement and avoiding subsidization seriously prejudicial to the trade or interests of contracting parties.

In 1963 the United States initiated an OECD review in which it sought, among other objectives, to bring a halt to the then-rapid movement of other countries toward broader and steeper indirect tax systems. This resulted in the creation of a Working Party of the OECD Council in 1965 to deal with the issue.

27-039 O - 78 - 16

In 1968, a GATT Working Party was established at the urging of the United States to seek agreement on principles for establishing tax neutrality in international trade, with particular emphasis on formulating rules which would not favor one type of domestic tax system over another.

During this same period, the U.S. also undertook a series of bilateral discussions with other countries. The goal of these discussions was to persuade our trading partners to halt or restrain their use of internal tax systems and border adjustments in ways which distorted international trade.

This was a major and multi-faceted effort on the part of the United States to bring fairness to the export subsidy rules. The U.S. position on the indirect-tax issue was vigorously expressed in the official statement of the U.S. representative to the GATT Working Party on April 30, 1968:

> ... [B]order tax adjustments do not neutralize the effects of taxes on trade. Instead, they are export promoting and import restricting for the indirect tax countries. The basic assumptions underlying the GATT provisions are not realistic. The full border tax adjustment provided for with respect to indirect taxes constitutes both an export subsidy and an import surcharge....

The U.S. goals, as stated to the GATT Working Party, were as follows:

> First, we should like to have a serious comprehensive discussion of whether there should in fact be border adjustments to compensate for national differences in taxation. There are no adjustments for a wide range of government measures which directly affect prices, nor for many forms of taxation which affect prices. Why then should governments make specific border adjustments for certain types of taxes? When governments adopt new domestic economic policies which have side effects on trade or payments, domestic action is not necessarily accompanied by offsetting action to neutralize the balance-of-payments effect. Many government actions, for example, affect general price levels. But only in the case of indirect tax measures is there an institutionalized provision for such offsets. What is the characteristic of indirect taxation that makes it uniquely qualified for automatic border adjustments?

That this constituted a major U.S. negotiating initiative is evidenced by the participation of all U.S. agencies involved in international trade. As the Department of Commerce noted:

> The U.S. initiative was launched after considerable study within the Administration. There is concern that U.S. trade may be adversely affected by the interplay of changes in foreign taxation and the GATT rules governing border taxes. 4/

4/ International Commerce, U.S. Dept. of Commerce Weekly, Oct. 7, 1968, at 2.

The U.S. effort was also vigorously supported by the Department of State:

> The widespread and increasing use of indirect taxes has required us to look carefully at the GATT rules. We think these rules--which sanction levies and rebates for indirect taxes but permit no comparable adjustment for direct taxes on business profits--give a competitive edge to countries whose fiscal systems rely heavily on indirect taxes. Something is amiss when GATT rules enable countries to stimulate exports and impede imports simply by altering their tax structures. 5/

And by the Department of the Treasury:

> Nontariff barriers abound in the present world.... A leading case in point is the trade consequences inherent in the international rules for border taxes and subsidies with domestic turnover or value-added taxes. Countries without these domestic taxes, such as the United States, are placed at a relative disadvantage--a disadvantage that becomes more pronounced as value-added tax systems become more widely adopted and levels of rates rise. 6/

The issue was even deemed sufficiently important to warrant specific discussion by President Johnson in his 1968 Balance of Payments Address:

> American commerce is at a disadvantage because of the tax systems of some of our trading partners. Some nations give across-the-board tax rebates on exports

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5/ Press release accompanying address by Assistant Secretary of State for Economic Affairs Anthony M. Solomon to the World Affairs Council of Northern California, Nov. 12, 1968.

6/ Remarks by David M. Kennedy, Secretary of the Treasury, at Hot Springs, Va., May 20, 1970.

> which leave their ports and impose special border tax charges on our goods entering their country.

This, then, was a major effort by the United States, well-founded in logic and equity and made with the full support of all branches of the U.S. Government.

It failed completely. The governments of Europe and Japan simply refused to entertain any possibility of meaningful compromise or revision of the rules which so favor their exporters. As a consequence, three years of negotiations in the OECD Working Party produced no agreement. The GATT Working Party also labored for three years, but in the end yielded only an agreement among GATT members to consult over possible trade effects of future changes which they might make in their domestic indirect taxes. Seven years later, no such consultations have yet been held. Finally, no significant results were achieved in any of the bilateral negotiations. In most cases, both the rates and the product coverage of foreign indirect tax systems are greater now than when the U.S. efforts began in the mid-1960s. So probably are the direct-tax export incentives, although by their nature they are less readily quantifiable.

For the U.S. negotiators, this initiative proved a frustrating and disillusioning experience. In this regard, witness the statement of Dr. Harald B. Malmgren, then Assistant Special Representative for Trade Negotiations:

> I must say parenthetically here that it is very confusing to have European governments formally and openly mention to their business community the trade effect as one of the reasons for their tax changes at any given moment, and then tell us at the negotiating table that there is no significant effect. 7/

The United States has not given up the battle, however. In almost identical language, both the House Committee on Ways and Means and the Senate Committee on Finance, in reporting on the Trade Act of 1974, directed the Executive Branch to use the negotiating authority delegated by that Act to bring about a revision of the international rules on use of tax devices to subsidize exports:

> Your committee also believes that GATT provisions on tax adjustments in international trade should be revised to ensure that they will be trade neutral. Present provisions permit adjustments on traded goods for certain indirect taxes but not for direct taxes. The committee expects that the President will seek such modification of present rules as would remove any disadvantage to countries like the United States relying primarily on direct taxes and put all countries on an equal footing. 8/

7/ Malmgren, "The Border Tax Problem: Tax Harmonization in Europe and U.S. Business," 17 Canadian Tax Journal 34, 39 (Jan. - Feb., 1969).

8/ Report of the Committee on Ways and Means to accompany H.R. 10710, House Report No. 93-571, 93rd Cong., 1st Sess., page 27.

In keeping with this directive, U.S. negotiators have offered a series of export subsidy proposals in the current Multilateral Trade Negotiations in Geneva. The aim of these proposals is to restrain, and in some cases to prohibit, various types of tax and non-tax subsidies in the context of a new international code or set of rules on this subject.

Senator STEVENSON. Thank you, that is very helpful. The other Mr. Hammer now.

STATEMENT OF THOMAS A. HAMMER, ASSISTANT DIRECTOR FOR NATIONAL AFFAIRS, AMERICAN FARM BUREAU, WASHINGTON, D.C.

Mr. THOMAS HAMMER. Thank you, Mr. Chairman. It is indeed rare that I sit on a panel with another Hammer, I have hardly ever met one, let alone sat with one. I wonder if you are from Texas.

Mr. RICHARD HAMMER. I might be.

Mr. THOMAS HAMMER. I will try to make this brief. I will confine my remarks, Mr. Chairman, to the harmful effects of agricultural export subsidies. The Farm Bureau has supported for a long time a high and expanding level of international trade, but they have believed that it must be based on fair and effective competition.

We believe fair competition cannot exist unless the terms of sale represent fully the economic incentives that bring forth the production and delivery of a commodity.

Export subsidies place efficient producers at a disadvantage. They force these producers to compete against Government treasuries, and they also tend to depress world prices to levels which do not reflect the true economic values of products. Export subsidies in many cases indicate either inefficient production or the failure of Government policies or programs. Export subsidies tend to retard the market adjustments that are needed to bring supply and demand into balance.

I will try to skip some of this. I would say farmers and ranchers have demonstrated that they have been able to compete for export markets by their record during the last few years. Much of this is in spite of many forms of trade impediments, including the use of export subsidies by foreign competitors.

Subsidies bestowed by foreign governments on products exported both to the United States and to third countries significantly distort international trade and have placed competing U.S. agricultural producers at a disadvantage.

They make the task of maintaining or expanding agricultural exports extremely difficult.

At the end I will try to summarize briefly a complex subject, and that is the European Community and their use of subsidies. There has been an effective remedy which can be applied when subsidized products are exported to the United States. The U.S. contervailing duty law, originally enacted in 1897, requires the imposition of duties to offset any bounty or grant paid or bestowed on imports. Countervailing duties are an appropriate retaliatory action against subsidized exports entering our domestic market. Such duties are not protectionist but rather a reaction to the initial decision of an exporting country to subsidize commodities destined for the United States. Countervailing duties should offset in full the subsidies paid directly or indirectly by foreign governments and should be applied promptly whenever a bounty or grant is determined to exist.

We vigorously supported tho enactment of the Trade Act of 1974.

However, we oppose the subsection of that act which gives the Secretary of the Treasury 4 years of discretion to withhold the application of countervailing duties. We do believe countervailing duties should be mandatory and immediate whenever a foreign subsidy exists.

Because the countervailing duty law predates the GATT, it is not subject to the GATT injury requirement. If it were subject to that requirement, substantial injury or harm due to the subsidized imports would have to be determined prior to the imposition of duties. The United States must insist on its right to maintain its present countervailing duty law without an injury requirement. If exports to the United States are not subsidized, then there is no need for the imposition of these offsetting duties.

Now I would like to hit on the export subsidy policy of the European Community. The Common Market Agricultural policy of the European Community was created and put into effect in about 1962. The subsidies are one-half of the basic agricultural policy. The other half is that of the levy.

Now, without going into a great deal of detail, in one way or another, almost every agricultural product the European Community produces is eligible for some form of subsidy. There is generally little, if any, budget restraint on how much money is allocated to this. And they can, in many cases, sell at a loss or fix prices well in advance.

Now why is this necessary? The European Community is protecting its production at a very high level, which therefore has raised much of their production costs above world prices. Having done that, they have to stop imports from coming in or else these could be sold and undercut the domestic competition.

This high level of support has encouraged a surplus for use within the Common Market. Having done that, many times the only way to relieve themselves of these burdensome surpluses is to subsidize them back out on the world market.

So in many cases they collect duties, levies from imports, use these same duties or levies to subsidize the products back into third country markets or in some cases into their own market.

This has put us at a very severe disadvantage, first of all, in entering their market because of their levy system. Not only that, but once they have brought forward this production, we find ourselves being undercut for many of our agricultural markets in third countries.

The table in my statement describes that in more detail.

I am a little timid to try to explain the European countries' policies on a page, so I will stop there.

[The complete statement of Mr. Thomas Hammer follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
BEFORE THE SUBCOMMITTEE ON INTERNATIONAL FINANCE OF
THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
WITH REGARD TO U.S. EXPORT POLICY

Presented by Thomas A. Hammer, Assistant Director, National Affairs
March 9 1978

We appreciate this opportunity to express Farm Bureau s views on the export policies being employed by our competitors. Specifically we wish to comment on the harmful effects of export subsidies.

For the record Farm Bureau is the largest general farm organization in the United States with a membership of 2,895,357 families in forty-nine states and Puerto Rico. It is a voluntary, non-government organization, representing farmers and ranchers who produce virtually every agricultural commodity produced on a commercial basis in the country.

Farm Bureau vigorously supports a high and expanding level of mutually advantageous international trade; however, it is essential that the expansion of international trade be based on fair and effective competition. Fair competition cannot exist unless the terms of sale reflect fully the economic incentives that serve to bring forth the production and delivery of a commodity. Unfair competition exists when a government bestows a bounty or grant directly or indirectly on the production or export of a commodity.

Export subsidies place efficient producers at a disadvantage. They force these producers to compete against government treasuries, and they also tend to depress world prices to levels which do not reflect the true economic values of products. Export subsidies in many cases indicate either inefficient production or the failure of government policies or programs. Export subsidies tend to retard the market adjustments that are needed to bring supply and demand into balance.

American farmers and ranchers annually produce far more food than is required for domestic consumption due to our highly efficient and productive agricultural system. They have demonstrated their ability to compete for export markets in spite of the fact that many U.S. agricultural exports are subject to some form of trade impediment, including the use of export subsidies by our foreign competitors.

Subsidies bestowed by foreign countries on products exported both to the United States and to third countries significantly distort international trade, place competing U.S. agricultural producers at a disadvantage, and make the task of maintaining or expanding agricultural exports extremely difficult.

Attached to this statement as Appendix A is a description of the export subsidy policies of the European Community which serves to illustrate the extensive nature of government intervention.

There is a very effective remedy which can be applied when subsidized products are exported to the United States. The U.S. countervailing duty law, originally enacted in 1897, requires the imposition of duties to offset any "bounty or grant paid or bestowed" on imports. Countervailing duties are an appropriate retaliatory action against subsidized exports entering our domestic market. Such duties are not protectionist but rather a reaction to the initial decision of an exporting country to subsidize commodities destined for the United States. Countervailing duties should offset in full the subsidies paid directly or indirectly by foreign governments and should be applied promptly wherever a bounty or grant is determined to exist.

Farm Bureau vigorously supported the enactment of the Trade Act of 1974. However, we strongly opposed subsection 303(e) of Title III of the Act which gives the Secretary of Treasury one to four years of discretion (depending upon certain circumstances) to withhold the application of countervailing duties. Countervailing duties should be mandatory and immediate whenever a foreign subsidy exists.

Because the countervailing duty law predates the General Agreement on Tariffs and Trade (GATT), it is not subject to the GATT injury requirement. If it were subject to that requirement, substantial injury or harm due to the subsidized imports would have to be determined prior to the imposition of duties. The United States must insist on its right to maintain its present countervailing duty law without an injury requirement. If exports to the United States are not subsidized, then there is no need for the imposition of these offsetting duties.

Countervailing duties can be used to offset subsidies on imported goods, but they are no solution to the problems of unfair competition created by the subsidized exports of other nations to third country markets.

Section 301 of the Trade Act of 1974 provides an avenue of relief against foreign import restrictions and export subsidies. Under this section the President may suspend, withdraw, or refrain from applying trade concessions, or he may impose duties or other import barriers on a product of a country that provides subsidies, or other incentives having the effect of subsidies, for export to the United States or to other countries, that have the effect of substantially reducing sales of competitive U.S. products either in the the United States or in foreign markets. However, during the limited time this provision has been in effect, it has not proved to be very effective in dealing with the problem of subsidized exports to third country markets.

A key issue for the United States in the current Multilateral Trade Negotiations (MTN) involves subsidies. A major U.S. agricultural objective at the MTN should be the elimination of export subsidies. We firmly believe that an effective code prohibiting the use of direct or indirect subsidies is highly desirable in order to eliminate unfair competition and the need for countervailing duties.

If the current Multilateral Trade Negotiations do not develop an international subsidy code which would cause exporting nations to refrain from the use of export subsidies, there is a very real chance that those nations now competing for new markets or attempting to maintain current markets without subsidies may themselves resort to the use of subsidies. For the reasons mentioned earlier in this statement, such a situation would create very serious problems.

In recent years the United States has refrained from the use of export subsidies for agricultural products. We sincerely hope that our government does not return to a position of subsidizing our agricultural exports; however, there is always the potential threat that the United States may be forced to resort to the use of subsidies in order to counteract actions by our foreign competitors which reduce sales of competitive U.S. agricultural products.

A "subsidy war" would not be in the interest of any exporting nation. Farm Bureau believes that it is far better to compete for markets on the basis of comparative advantage. The American farmer has achieved great success by competing in export markets. In fact, U.S. agricultural exports have increased from $6.7 billion in 1970 to over $24 billion in 1977. We are confident that further increases of this magnitude are possible if U.S. farmers and ranchers are allowed to compete without impairment by policies adopted by other countries either to stimulate their own exports or to hinder imports from foreign sources.

We thank you for this opportunity to express Farm Bureau s views on this important issue.

APPENDIX A

Export Subsidy Policy of the European Communities

Since 1962 the EC has maintained a system of export subsidies or restitution payments on agricultural products. Virtually all agricultural products and some industrial products are now covered by this system. Products eligible for these export subsidies include all live cattle and calves, swine, poultry, fresh and processed meat of these animals, fish, milk, butter, cheese and all other dairy products, eggs and egg products, all fresh and processed fruits and vegetables (except potatoes, peas and beans and some tropical fruits and nuts), all grains and grain products, rice and rice products, lard, animal feeds (containing grain or milk products), processed foods containing grain products, milk, sugar or eggs), tobacco, and wines, non-alcoholic beverages, mannitol or sorbitol products, various chemical (acids, salts, and esters and other industrial products.

In addition to granting direct export payments, the EC may sell for export at a loss commodities such as tobacco, grain, and dairy products which it acquired under price support operations.

Subsidy payments for most producers are based on the difference between the internal EC price and the price needed to make the sale to each destination. Payments may be fixed at a different level for each destination. For processed foods, feeds and industrial products the subsidy rate is derived from the rate set for the basic grain, milk, or sugar. The quantity that can benefit from an export subsidy is not limited. Nor is there any limit on the expenditure of EC funds for subsidy purposes.

A common feature of the EC subsidy system is a provision for fixing the amount of the subsidy in advance of exportation. How far in advance varies by commodity. Advance fixing is currently authorized for grains and grain products, rice and rice products, olive oil, rapeseed, poultry eggs, dairy products, sugar, and processed agricultural products.

The funds used for the export assistance program come from the European Agricultural Guidance and Guarantee Fund, which is financed by the EC. Approval of the annual budget for the Fund in no way limits its expenditures. Accounting for funds spent does not take place until the end of the year.

Basic export subsidies in effect toward the end of February 1978 for certain commodities were as follows ($ per 100 kg.): butter, 230.5; whole broilers, 22.46; beef (carcass), from 87.6 to 109.3. Export subsidies on most grains were suspended. However, sales of barley to certain non-EC European countries received a basic subsidy of up to $101.2 per ton.

The attached table presents the export refund payments for the years 1973 to 1976 by commodity groups.

Total Amount of Export Refunds 1

Description	Calendar Year (Millions of Dollars)			
	1973	1974	1975	1976 2
Cereals	655.96	95.13	452.76	493.67
Rice	13.14	0.63	4.75	35.16
Milk Products	951.33	427.50	433.62	947.65
Oils and fats	3.22	1.00	0.92	10.08
Sugar	68.70	10.00	48.97	119.95
Beef and Veal	3.97	69.38	190.34	187.24
Pigmeat	119.91	69.38	52.01	52.92
Eggs] Poultry meat]	28.89	21.13	11 09	25.20
Fruits and vegetables	32.36	22.38	45.94	56.57
Wine	0.74	0.13	0.40	5.04
Tobacco	---	1.00	2.38	7.56
Totals	1.878.22	717.56	1.243.18	1.942 04

1/ Export refunds shown do not include indirect export subsidies resulting from the sale of intervention stocks at less than acquisition cost.

2/ Total of the 1976 budgetary appropriations and of the second supplementary budget for 1976.

Senator STEVENSON. Thank you. Finally, Mr. McCloskey.

STATEMENT OF PETER F. McCLOSKEY, PRESIDENT, ELECTRONIC INDUSTRIES ASSOCIATION, WASHINGTON, D.C., ACCOMPANIED BY PETER LEVIN, CHAIRMAN OF THE INTERNATIONAL BUSINESS COUNCIL, EIA

Mr. McCLOSKEY. We have submitted a much longer statement for the record. I will summarize.

Senator STEVENSON. All right, all statements will be placed in the record.

[The statement read by Mr. McCloskey follows:]

STATEMENT
of
March 9, 1978
on
FOREIGN GOVERNMENTS' POLICIES
IN SUPPORT OF EXPORTS
(as compared with)
U.S. Export Policy
to the
Subcommittee on International Finance
of the
Senate Committee on Banking
by EIA

The Electronic Industries Association (EIA) applauds your Subcommittee for conducting this series of hearings, and appreciates these opportunities to express its views. Prior to our testimony today, EIA submitted its statement on "Floating Exchange Rates" for your February 6 hearing. Subsequent to today's hearing, we will testify on "Extending the Export-Import Bank's Operating Authority" at your March 21 hearing. And, we hope for further opportunities to participate, as your Subcommittee's study of the factors affecting U.S. EXPORT PERFORMANCE AND EXPORT POLICY proceeds into the Spring of this year.

In this same context, EIA has also submitted its statement on "Trade Deficit" last November to the Trade Subcommittee of the House Committee on Ways and Means; and will, later this month, submit its statement on "Reauthorization of the Export-Import Bank" to the International Trade, Investment, and Monetary Policy Subcommittee of the House Committee on Banking, Currency, and Housing.

We respond so readily, as these opportunities arise, because our 285 member companies manufacture electronic components, assemblies, end-products, and systems in the USA and market them -- for consumer, commercial, and governmental end-uses -- throughout the world. They do so with reasonable success, but if the U.S. Government could support our exports so effectively as foreign governments support theirs, our companies are confident that they could do far better. American electronic products are among this economy's most exportable Manufactures.

While a great deal of attention has been given to the growing share of the U.S. market being taken by imports, we feel it incumbent to note that in the international trade of our industries this country enjoys a positive balance. While the figures for 1977 are not yet final, it is apparent that:

- about $2.5 billion more of electronic products were exported from the USA in 1977 than were imported.
- of some $45 billion worth of U.S. factory sales, over $11.5 billion were exported.
- of some 1.2 million Americans directly employed by U.S. manufacturers of electronic products, the jobs of some 260,000 are directly attributable to exports.

At something over 25 percent of their annual U.S. production, the export performance of the electronic industries manifestly exceeds the national export averages which in recent years have amounted to 7 or 8 percent of this country's Gross National Product (GNP) and about 16 to 18 percent of its goods-producing sector.* Yet, high as our exports might seem by comparative U.S. standards, especially for the purposes of this hearing, it is worth noticing that amongst Japan and the industrialized European nations as well

* Comprising manufacturing, agriculture, mining, fisheries and forest products.

27-039 O - 78 - 17

as Canada, exportation ranges in amount from at least one-quarter to over three-fourths of the values of their domestic production.

There is profound significance to a national economy when such high proportions of its production regularly find their way into export rather than national markets. Whether or not the goods themselves are differentiated in order to meet various standards of design and customer preference or simply differentiated by statistics according to destination, it is evident that in these countries foreign markets have become vital to the firms that supply them -- and thus to their national economies. A decline in exports, or even a static foreign demand, invests these economies with the same problems that occur when recession hits the U.S. domestic market -- increasing unemployment, rising costs, reduced profitability, more bankruptcies, bigger governmental deficits, and stagflation.

While EIA cannot define a hard-and-fast percentage at which the mix of home-market vs. export business becomes critical to either a firm or a national economy, it will be apparent to this Subcommittee that an absence of growth or absolute shrinkage in - say - 20 percent of a company's production has both immediate and long-run adverse consequences. Similarly, where 25 or 30 percent of a nation's production base can be thus impacted by conditions of external demand for its goods, export dependency obviously becomes interwined with the national economic health. In some degree, then, the country itself arrives at a point where -- in matters of national policy and practice -- production for export and production for home-market consumption are no longer wholly separable.

It is EIA's observation that, as a result of such interdependency, the basic national policies, practices and attitudes of export-oriented countries toward corporate financial structures contrast sharply with those of the United States. This is illustrated in Exhibits I and II, where we show how the differing national regulations and customs that govern business debt-equity ratios for the financing of company operations carry startling effects on market competitiveness.

EXHIBIT I

COMPARATIVE CAPITAL SERVICE REQUIREMENTS - I

Pro-Forma Analysis of Effects of Differing Rules Governing Debt/Equity Ratios

	U.S.		Japan		Western Europe	
Debt/Equity Ratio	1/3	1/2	4/1	3/1	2/1	1/1
Sales turnover: Capital employed	1:1	1:1	1:1	1:1	1:1	1:1
Idealized market price	100	100	100	100	100	100
Interest cost - 9%	2.3%	9.0%	7.2%	6.8%	6.0%	4.5%
Pre-tax profit - 36%	27.0	24.0	7.2	9.0	12.0	18.0
Corporate tax - 50%	(13.5)	(12.0)	(3.6)	(4.5)	(6.0)	(9.0)
After-tax profit	(13.5)	(12.0)	(3.6)	(4.5)	(6.0)	(9.0)
Capital Service Needs as % of price	29.3%	27.0%	14.4%	15.3%	18.0%	22.5%
Advantage over U.S.			14.9-13.6%	14.0-11.7%	11.3-9.0%	6.8-4.5%

EXHIBIT II

COMPARATIVE CAPITAL SERVICE
REQUIREMENTS - II

National Analysis of Effects of Differing
Rules Governing Debt/Equity Ratios
Based on 1970-77 Data

	U.S.		Japan		Western Europe	
Debt/Equity Ratio	1/3	1/2	4/1	3/1	2/1	1/1
Sales turnover: Capital employed	2.5:1	2/1	1.4:1	1.3:1	1.4:1	1.75:1
Idealized Market Price	100	100	100	100	100	100
Interest cost[2]	0.8[a]	1.4[b]	5.7[c]	4.3[d]	3.9[e]	1.9[f]
Pre-tax profit	11.5	11.5	3.0	4.1	5.5	7.2
Corporate tax[2]	(5.5)[g]	(5.5)[g]	(0.9)[h]	(1.2)[h]	(1.9)[i]	(2.9)[j]
After-tax profit[3]	(6.0)[k]	(6.0)[l]	(2.1)[m]	(2.9)[m]	(3.6)[m]	(4.3)[m]
Capital Service Needs as % of Price	12.3%	12.9%	8.7%	8.4%	9.4	9.1
Potential Reduction from Idealized Market Price	0.6%	-	4.2%	4.5%	3.5%	3.8%

NOTES:
1 Interest rates averaged as follows: (a) 8%, (b) 8.5%, (c) 10%, (d) 8%, (e) 11%, (f) 6.5%
2 Corporate income taxes applied at the following effective rates: (g) 48%, (h) 30%, (i) 35%, (j) 40%
3 After-tax retained profits on equity at the following annual rates: (k) 20%, (l) 18%, (m) 15%.

- Both Exhibits take the same point of departure: debt/equity ratios which are characteristic of successful multi-product manufacturing exporters in the U.S., Japan, and Western Europe. Such American companies finance their operations with approximately one part of debt for each two or three parts of equity. Japan firms reverse this financial underpinning with three to four parts debt for each part of equity. The European businesses range from equal reliance among the more conservatively financed to a 2:1 ratio that is more generally the case. It should be noted that "debt" comprehends here both long and short term obligations; "equity" includes paid-in-capital, surplus accounts, and various capital reserves.

- The focus of these Exhibits is on one -- and only one -- consequence of the differing national structures: the obligations which they place upon market price in order to support a viable return on the types of capital - interest on borrowings and pre-tax profits on equity. As models for comparison, and especially in the instance of Exhibit I all other facets are necessarily presumed to be equal; that is, the various models establish no other competitive difference or advantage between companies. Thus, for each country here represented, the idealized market price is set at 100 -- a figure which can be considered as any of the following: (i) a world equilibrium price, (ii) a U.S. market price, or (iii) a price applicable to the imports of third markets.

- Exhibit I is almost wholly pro forma. At a ratio of 1:1 for the turnover relationship between sales to employed capital, these examples are typical of U.S. capital-intensive operations such as heavy chemicals and aluminum smelting, or long-cycle production such as specialty equipment, but are decidedly untypical of manufacturing businesses such as electronic components, assemblies and consumer products. So too, for all countries we have utilized identical interest rates (9 percent), identical pre-tax profitability on equity (36 percent), and an identical rate of corporate income taxation (50 percent). Nevertheless, EIA believes the comparison to be instructive. For, with all else at parity, minimal capital service needs afford Japanese firms a cost advantage over U.S. companies that ranges between 11.7 and 14.9 percent; European firms enjoy an advantageous range of 4.5 to 11.3 percent. And, if capital service needs were the only competitive consideration in price offerings, it is therefore obvious that comparative capital financing policies and practices in other industrialized countries place U.S. companies at a substantial competitive disadvantage.

- In connection with both Exhibits, however, it must be recognized that after-tax profit serves several financial imperatives. In addition to covering a dividend to shareowners (as is the case of numerous producers in all countries), these earnings help to liquidate and/or roll over term borrowings as well as providing basis for new capital formation within the firm. To the extent that after-tax profits can perform these several economic functions, the expectation of higher retained earnings which is inherent in the U.S. system might - if realized - render an American firm more independent of the money market; but, on the other hand, our companies are much more sensitive to both market-price fluctuations and revisions to the corporate taxation laws. What Exhibit I makes clear is this: export competitors based in foreign countries have considerably greater price flexibility and -- all else being equal -- can meet head-to-head U.S. competition through price reduction without significant reduction in their financial expectations or imperatives.

- Exhibit II more closely approximates recent and contemporary conditions. The variances here introduced reflect differences between countries in turnover of employed capital, in corporate income taxation at effective rates, in average annual interest rates, and in profit needs and expectations. The Exhibit's footnotes state the variances which have been utilized in the tabular calculations. As in Exhibit I, all other operational costs are presumed equal.* Again, it is evident on comparison that U.S. companies are placed at a meaningful disadvantage against their foreign competitors as a result of differing national policies and practices

* By establishing this parity for illustrative purposes, we do mean to suggest that such is indeed the fact. Differences in detail exist, of course, between countries in employment costs, prices paid for purchased materials, permissible depreciation charges, other types of taxation, etc. And these differences in detail can and do add up to differences in total cost.

affecting corporate financial structures. That measurable disadvantage -- which involves no sacrifice by the competitors -- in terms of potential or prospective price reduction ranges between 3.5 and 4.8 percent. To this range can be added the not uncommon practice of many competing foreign companies to forego some or all of their normal pre-tax profit margins on exports to the United States and third markets. It follows, then, that in order to meet the price-competitive thrust of foreign exporting firms, U.S. firms selling abroad necessarily reduce their own pre-tax profit margins below normal on export goods.* And concomitant with such a reduction comes some substraction in the functions which a normal after-tax (retained) earnings rate would perform - provision of funds for repayment of borrowings, expansion of equity capital, dividends yields, and the attraction of new equity capital as well as borrowings at lower interest rates.

The conclusion to be drawn from these Exhibits is inescapable: even if all else were equal, American companies enter the competitive struggle for exports at a pricing disadvantage because of a partly mandated, partly customary series of policies and practices governing financial structures. This disadvantage, it is emphasized, is long-standing, not recent. Yet, it is at least conjectural whether it is possible or desirable for the United

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* This point has particular relevance to our discussion of the Domestic International Sales Corporation (DISC) at pp. 22-28.

States to make the direct structural and institutional adjustments that would lead to international equalization:

- For one thing -- new capital formation as evidenced by secured loans and equity being heavily dependent upon savings -- the rate of personal savings in this country has historically been much lower than in Europe and Japan. In the short term at least, rectification through meaningful increase in the U.S. personal savings rate - a process involving mandatory or at best non-too-subtle governmental pressures -- would cause a decline in consumer spending and a reduction in societal expectations among middle and lower income groups.
- For another thing, adjustment which took the form of substantially increasing corporate debt structure while diluting equity and/or reducing after-tax profitability would, we suggest, play havoc with the markets for as well as owners of American corporate securities. Certainly, a strong shift toward borrowings (especially if accompanied by static or reduced dividending) would seriously and permanently depress the values of this country's pensions and trusts, of which equities and corporate bonds comprise so large a part.
- In any event, it is questionable whether a rapid shift to emphatic debt financing at the expense of existing bond and equity values -- as well as banking and corporate financial rectitude -- could be carried out within the existing rules and practices mandated by the SEC, the Federal Reserve Board and the Financial Accounting Standard Board.

Thus, long-standing and onerous though this disadvantage to American industry has been, there is no readily visible "quick fix" that might afford parity to U.S. exporters. This difference in financial cultures places an immediate entry burden on U.S. industry. Yet, it has not been recognized; nor have remedial measures been legislated or instituted toward counteracting it.

Traditionally, U.S. manufacturing companies were able to mitigate this and other competitive disadvantages: higher managerial efficiency as evidenced by more economical usage of capital and faster inventory turnover; markedly greater productivity per man-hour; faster rates of innovation in marketable products; unit cost savings through large-scale production operations; cheaper basic materials and energy; lower interest charges; and better marketing skills. But, gradually and perhaps inexorably, what were the factors which provided a competitive edge for the United States have been substantially blunted. In some instances, this country has retrogressed; in others, our foreign competitors have steadily cut down on the margin of our lead.

Simultaneously, the governments of other industrialized countries -- clearly recognizing the significance of exported manufactures as a source of employment and national prosperity -- have periodically expanded and improved their well-established export assistance and promotion programs, added new ones, and generally have tried to make certain that their national and regional policies reinforced rising export goals. Alongside these activities have been other but complementary policies, programs and practices that create barriers against competitive imports. Especially since the revival of world trade in the 1950s and its great expansion during the past 15 years, the types and numbers of sophisticated export-fostering and import-restricting programs and policies have proliferated. They are -- or so it appears -- as numerous as the fertile mind of man can develop, and constrained only by a grudging conformity to international rule and the cautionary instincts of national treasury ministers.

In this paper and the brief time available to us for its preparation, EIA could not possibly assemble a catalogue of the world's trade measures and practices which affect the products of our industries, as well as U.S. industry in general. Instead, we commend to the Subcommittee's attention those product-by-product, country-by-country listings that have been developed by the various Industry Sector Advisory Committees (ISACs) which, under the provisions of the Trade Act of 1974, have been providing consultation and advice to the President's Special Trade Representative. In their reports and in their meeting records reposes what is probably the most comprehensive description of international export barriers and incentives together with evaluations of their significance in distortions to U.S. trade.

While we would not attempt to duplicate the work of the ISACs, pursuant to the Subcommittee's interest in the extent and competitiveness of U.S. export programs in comparison to those of other countries, in this submittal we believe it important to state our views on those which have present and potential effect upon our diverse and differing industries:

- Export credits. At a subsequent hearing of this Subcommittee, EIA will offer extensive testimony on competitiveness, scope and operation of the U.S. Export-Import Bank and this country's credit insurance facilities. Here, therefore, we confine our discussion to certain export credit matters which, in our opinion, tend to receive short shrift in U.S. governmental discussions on the role of Exim Bank and other approaches to export finance.

Thus, because no such method exists in the U.S., there is a tendency to forget that some other governments encourage -- and some provide -- production finance loans to exporting manufacturers at concessionary (i.e., less than normal) interest rates. From country to country, the mechanism varies. In France, for example, the requisite funds can be borrowed directly from an affiliate of COFACE, the omnibus agency which oversees the country's export credit facilities, or from many of France's nationalized banks and insurance companies with the backing of an explicit or implicit COFACE guarantee. Japan's Export-Import Bank and, on occasion, the Ministries of Finance or International Trade and Industry implicitly guarantee such loans which are sourced from the nation's private banking system. Elsewhere, the central bank supplies the guarantee. Whatever the mechanism, and whether utilized for the engineering and manufacture of long-cycle capital goods or short-cycle mass production, the result is the same: a cost reduction to the manufacturer which is passed along in the price to the export customer. When such pre-shipment financing is combined with post-shipment export credits to the purchaser, the potency of such competition to American producers of like goods is obvious.

Competitive disadvantage also marks U.S. treatment of short-term credits to export customers who buy end-products or industrial intermediates. With the Exim Bank not offering direct loans for this purpose, the sole Federal program boils down to the insurance of customer borrowings from U.S. commercial banks by the FCIA. Under the best of circumstances, even if offered at the prevailing prime rate, such loans of course carry an added charge for the premium. Most other major industrial countries, however, have a facility for providing direct short-term loans at concessionary interest rates; if not that, then nationally-insured borrowings from the private sector are made available to export customers at reduced rates. Britain, for instance, relies wholly on the latter; the Federal Republic of Germany offers each as a choice, as well as mixtures of both.

This focus upon concessionary loans originating out of the commercial banking systems of other countries casts a different light on the availability of low-cost export credit to assist the sales of our competitors. Considering too that international trade has grown much more rapidly than the separate national economies, with Exim Bank as their only comparable credit facility it is clear that U.S. manufacturers have been attempting to export under distinct disadvantage. For, in this unequal contest, as Exim's own semi-annual reports on competitiveness demonstrate, the Bank capabilities of credit extension and expansion have shown a two-fold lag: (i) in respect to the growing resources of comparable institutions in other industrial countries, and (ii) in the face of a rapidly increasing usage elsewhere of commercial banking reserves and the mounting resources of semi-private special banking facilities.

- Government-Funded Research and Development. Even as Federally-sponsored research and development in the United States continues to decline (in real terms) from its previous levels of activity, EIA believes government funding in most other countries to be continuing with a relatively stable allocation of national resources. Traditionally, such U.S. research has long pursued a different course from that undertaken elsewhere: Here, the major emphasis in the electronic industries has centered upon military applications, other products for Government and medical instrumentation -- areas of direct governmental concern; but in both Western Europe and Japan, the emphasis has been and remains on products intended for commercial markets and essentially private usage.

To be sure, there is little news in the disparity between these R & D goals. In the instance of Japan the genesis of its TV-set manufacturing industry lay in just such development, as did her buregeoning growth as a producer of tape recorders and discrete electronic components. Later, the same process of subsidization led to the creation of an indigenous, home-controlled Japanese date processing equipment industry which today continues to receive both funding and the support of protective barriers against imports.

More recently still, very large development funds and domestic credits - variously estimated from $250 to $750 million - have been dedicated to creating a powerful Japanese industry for the production of very-large-scale integrated circuits (VLSIs) the most sophisticated solid state device generally available in the marketplace. Essentially, then, the Japanese subsidization approach to R & D centers upon the development of established products to domestic manufacturing techniques rather than toward original or derivative research.

European governmental subsidies for R & D in electronics carry a somewhat larger quotient of research. This is especially the case in telecommunications equipment where substantial governmental funds make their way into the private sector. It should be noted, however, that despite almost universal government ownership of telecommunications in Europe, the services themselves are essentially commercial. In addition, for more than ten years France has been heavily subsidizing its state-owned computer manufacturer in development programs as well as operations. But the commercial objectives of a large part of European funding is as obvious as the Japanese approaches.

Multiple Exchange Rates. Article VI of the GATT is quite explicit on multiple currency practices which constitute an export subsidy by causing the external value of a country's currency to be exchanged at rates which are lower than its domestic purchasing power. Such a practice is general to the East Bloc countries -- which maintain stringent exchange controls in order to insulate domestic prices from international prices. The combined effect of multiple exchange rates thus administered is, in terms of domestic prices, to overcompensate and thus subsidize the exporter by paying him in the national currency at a depreciated exchange rate. Conversely, at an identical rate, imports are penalized and, thus, the external depreciated rate becomes a trade barrier of itself.

Characteristically, where national currencies are freely convertible in the international money markets, only very narrow bands of multiplicity are possible -- and these differentials, having IMF concurrence, are not objectionable _per se_. Thus, EIA does not question the periodic resort of Belgium to slight exchange rate multipliers as a temporary balance of payments measure.

But in the East Bloc, an international trade multiplier can be twice or three times domestic purchasing-power parity. The East European exporter is thus compensated at twice or thrice the domestic purchasing-power value as he would receive on a domestic sale. In our view, such subsidy is blatant. It leads to sacrificial export pricing without penalty to the exporter. And, in light of the growing technological capability of COMECON countries in electronics together with an increasing stress on East-West trade, the continuation of wide bands of multiple valuations for non-convertible and rigidly controlled currencies stands as a potentially massive distortion of trade.

It is a concern, we believe, which belongs properly within this Subcommittee's jurisdiction.

- Border Tax Adjustment. Article VI of the GATT also provides, and at another point Article XVI, for the remission, waiver, and/or rebate of domestic indirect (i.e., consumption and ad valorem) taxes on exported goods and, concomitantly, for the border imposition at domestic rate of such taxes on imports. Conversely, direct (i.e., income, payroll, and the like) taxes may not be border adjusted as abatements or additional imposts.

It is EIA's position, as it is the more modern understanding of most tax economists, that a tax collected in the course of production and distribution -- whether directly or indirectly levied -- is an element of cost. No matter what its form, it is an expense just as are purchased materials and services, employment costs, interest charges, depreciation, and the like. Over any reasonable period of business activity, the tax's full cost recovery by the producer or seller is thus an economic necessity. And, in the normal workings of the marketplace, such cost recovery is achieved through the mechanism of price. In the marketplace, therefore, between two otherwise equal competitors a distinct price advantage inheres to the one whose product carries in its cost the lesser burden of taxation.

It follows, then, that in international trade the remission or rebate of a consumption tax on exports -- although in accord with GATT rule -- has the effect of a subsidy: that is, it reduces the price required for full cost recovery. The converse, imposition on an import at the border of a consumption tax, has the effect of a tariff.

In light of these border effects, advantage or disadvantage in trade between international competitors can easily turn on the disparities between the taxation systems of their respective countries. Inherently, at the manufacturers' level of selling, the preponderant reliance of the Federal government on direct taxation has competitive consequences: U.S. producers are placed at a relative disadvantage to those Western European and other counterparts whose national taxation systems look to indirect levies for a considerable proportion of their revenues.

More than a theoretical inequity is involved insofar as the disparity affects U.S. electronic exports. With European border tax rates on imports ranging between 8 and 20 percent (in addition to denominated tariffs) the inhibitions on U.S.-produced articles -- which already carry this country's full burden of direct taxes -- is severe. In some instances, imposition of the border tax effectively raises the price of similar and otherwise acceptable products above competitive levels. In other cases, the mere existence of the tax is sufficient deterrence to redesign of American goods as export models that would conform to European requirements.

Furthermore, in the export competition for third-country markets, the contest takes on a different inequality as our products face a

European output whose normal price has been reduced by border rebates of 4 to 10 percent, depending upon the country of origin. (It may be argued that a tax waived and thereby never paid is not a tax at all. Hence, on exports, the waiver on post-production value-added taxes (VAT) in Europe's multi-stage system of levies might be viewed by some as a tax liability that never existed. That, however, is not the point here: the European rebate on exports is actual, a remission by cash or tax credit covering the VAT on materials and services purchased during the process of their manufacture).

The U.S. Congress has recognized the true nature of this inequity in the Trade Act of 1974. There, at Paragraph 121(a)(5), it calls for "revision of GATT articles with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs." EIA of course heartily supports this instruction to the U.S. delegation at the Multilateral Trade Negotiations at Geneva. Its accomplishment would, we believe, be a most affirmative step toward trade liberalization and expansion by virtue of introducing greater competitive parity into the international marketplace. But, in the present outlook, we are not hopeful that the revision desired by Congress will find multilateral agreement. Border adjusting countries are strongly -- even jealously -- conscious of their trade advantage; and the United States has found neither the equitable revisionary formula nor the quid pro quo that will bring the issue into serious bargaining.

EIA realizes that the discussion above on border adjustment omits much substance as well as the large body of economic theory and taxation history which are pertinent to an extended exploration of the practice. Our brief review of the inequitable effects is just that, intended as advice to this Subcommittee on the especial effectiveness of such a national policy in other countries as an export incentive and deterrent to imports. In our opinion, on balance there is no other single and generic governmental practice so powerful as this one.

It was a recognition of that power which led to passage in 1971 of legislation permitting U.S. exporters to set up Domestic International Sales Corporations (DISCs) as a partial counterbalance against the inequities of border tax adjustment. Then as now, the DISC privilege of deferral of a direct tax was applicable solely to export, with no counterpart taxing of imports. For most products, the percentage value of the DISC deferral on a single transaction is and has been a minor fraction of the proportionate value of an export tax rebate. As a further difference, from the start it has been a requirement that the proceeds from DISC deferral be used in the development of additional U.S. exports; border tax rebates are, on the contrary, commingled in the operating funds of a business. In further contrast, whereas border tax rebates represent a cost recovery to seller, the quantity of DISC funds to be realized as a deferral is determined by the profitability of total shipments on what in effect is an annualized basis. Unlike the beneficiary of a rebate, if a U.S. exporter fails to profit he realizes no DISC benefits.

In the perspective of these differences, it is evident that the true worth of a DISC lies in its year-after-year accrual of an interest-free capital fund that grows, revolves, and is continuously invested in eligible export activities. To date, for electronics together with other U.S. exporting industries, three principle usages have absorbed DISC funds:

(i) As investment in the development and sale of products explicity adopted to export markets.

(ii) As use in initiating, expanding, and improving offshore market development programs.

(iii) As a means of reducing the higher costs of carrying accounts receivable on export shipments in contrast to domestic sales.

The first two types of expenditures normally require a lead-time measured in years before success becomes evident. Thus, only now are our companies -- and, thus, our employment and the U.S. national income -- beginning to realize the fruits of these long developmental efforts.

Depending upon the particular company and how it has elected to allocate the slow buildup of its DISC funds, the third type of utilization is today approaching the point where American exporters can feel some mitigation in two price competitive disadvantages inherent in our system: the debt/equity effect illustrated in Exhibit II, and the border adjustment problem discussed earlier in this submittal. Exhibit III herein serves as a nine-year accumulative model of how the third DISC usage reduces the otherwise high costs of carrying export receivables:

- Across the sales mix of electronic products the cycle time between an export shipment and receipt of payment from the customer averages 120 days. By contrast, the same cycle on shipments to U.S. customers averages only 50 days. Thus, the higher cost in capital service charges on export sales. Reference to Exhibit II demonstrates that, in the absence of any DISC coverage of these charges, the added cost to an exporter would be approximately 5 percent -- or slightly less than half of his expected pre-tax profit.
- Since our model utilizes throughout the DISC retention rates of the original law, instead of factoring in changes wrought by the 1976 amendment, it compresses the actual time period when accumulated deferrals and cash lock-ups fully compensate the cost of excess receivables. Nevertheless, even under the older rule, nine years would have been required to full compensation. After such a period, it is worth noting that the benefit barely equalizes the price reductions made possible immediately at the lower end of VAT tax rebates. Counterbalance to the higher (10%) VAT rebates, under current law, requires at least 15 years.
- Further reference to Exhibit II suggests that DISC benefits equalize the U.S. debt/equity disadvantage against European competitors in

about 6 years, against Japanese companies in 7 to 8 years. It should be remembered, however, that the period spent countering this one advantage substantially extends the time required to overcome the second, border rebates.

- It is, we suggest, a fair inference from Exhibit III that, given sufficient time for DISC deferrals to operate, the corporate income will enormously exceed the alleged revenue short-falls which the U.S. Treasury is supposed to have suffered in recent years. Careful analysis, we suggest, would disclose that by any reasonable examination of export profitablity owing to the DISC, the crossover point is imminent, or may indeed have been passed.

EXHIBIT III

HOW DISC FINANCES
EXCESS RECEIVABLES
A Model for the U.S.
Electronic Industries

	1972	1973	1974	1975	1976	1977	1978	1979	1980
Export Sales[1]	100.0	115.0	132.0	152.0	175.0	201.0	231.0	266.0	306.0
50% of DISC Commission Income[2]	3.0	6.5	10.4	15.0	20.2	26.3	33.2	41.2	50.3
Tax Deferral (Cumulative, including return on deferral)[3]	1.5	3.3	5.4	7.9	10.8	14.3	18.3	23.0	28.5
Exporter's Cash Lock-up (Cumulative)	1.6	3.5	5.8	8.5	11.7	15.4	19.8	25.0	30.9
Total DISC Funds	3.1	6.8	11.2	16.4	22.5	29.7	38.1	48.0	59.4
Export Receivables[4]	33.3	38.3	44.0	50.7	58.3	67.0	77.0	88.7	102.0
Excess Receivables[5]	19.4	22.3	25.7	29.6	34.0	39.1	44.9	51.7	59.5
DISC Funds as % of Excess Receivables	16.0	30.5	43.6	55.4	66.2	76.0	84.9	92.8	100.0

Notes
1 Export Growth at 15% per annum
2 Profit Margin on Exports at 12%
3 Earnings on Deferred Tax at 8%
4 Export Receivables Average -- 120 days
5 Domestic Receivables Average -- 50 days

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Our model obviously proclaims the power and potential of the DISC as an export incentive. But how closely does reality match the assumptions of Exhibit III, particularly that dealing with a 15 percent export growth rate?

In our judgement, Exhibit IV validates these premises. Electronic exports since 1969 have grown at an 18.8 percent compound rate in current dollars. Despite some quite apparent cyclical factors affecting total domestic production and the added burden of import problems in some product areas, the upturn in exports after 1973 is unmistakable and dramatic. That this parallel an increasing availability of DISC funds is, we believe, no coincidence. Moreover, the 1975-77 steadiness where exports now regularly account for over one-fifth of our sales has made this supply of offshore customers essential to the vitality of the U.S. industry.

EXHIBIT IV

EXPORT GROWTH
OF THE U.S.
ELECTRONIC INDUSTRIES
1969-1977
(in millions)

Year	U.S. Domestic Production	U.S. Export Shipments	Export % of Production
1969	$28,522	$2,894	10.1%
1970	26,906	3,560	13.2
1971	27,832	3,414	12.2
1972	31,574	3,548	11.2
1973	34,376	3,844	11.2
1974	36,288	5,227	14.4
1975	34,979	8,353	23.9
1976	38,881	8,417	24.6
1977	45,500 (est.)	11,500 (est.)	25.3 (est.)
Compound rate 1969-77		18.8%	

The significance of this growth, the fact that established DISCs are just beginning to reach strength, has not been lost on this country's trading partners. Hence, their strong efforts to cause its termination by government-to-government protests and attacks on its legality in the GATT. To them, the DISC is among the most potent of U.S. export incentives. For our part, we doubt that its equal could, from the viewpoint of U.S. foreign economic policy and nationally acceptable programs, be devised.

Clearly, if the U.S. national interest requires exportation -- and EIA contends that it does -- the DISC is at the threshold of success. It deserves the endorsement of the President and the Congress. Yet, to our alarm, its home-grown attackers seem -- in decibels, at least -- to outweigh its defenders, and are bent on its destruction. EIA urges this Subcommittee to help reverse the momentum of such a direction. For, to destroy the DISC is to destroy an increasing percentage of U.S. jobs which are tied to increasing exportation. With that destruction comes atrophy to one of the most vibrant sectors of our national economy.

We have reviewed the various export support programs provided by our trading partners around the world and compared them with those available to U.S. industry as it does business overseas. It should be painfully apparent that the balance is heavily weighted in favor of our competition. The U.S., stands alone in its hands-off attitude toward international trade. No matter what manner of support is considered, whether it be tax policies, the management of export licensing, or export financing, the other major industrialized nations of the world offer far more government assistance than does the U.S. We submit that until this country recognizes the need for a cohesive international economic policy, one plank of which will recognize the importance of international trade to the health of the domestic economy, this imbalance will continue.

EIA/IBC/3-9-78

Senator STEVENSON. Thank you Mr. McCloskey.

Mr. Frank, you place most of your emphasis, or much of it, on the credit facilities and resources available to the Japanese.

Now you have heard some emphasis on comparative levels of taxation. Have you done any work on that subject? Can you tell us a little bit about comparative levels of corporate taxation in the United States, Japan, and perhaps other countries?

Mr. FRANK. I would like to defer an answer there, because I can't recall from memory. I believe I have some of the data here, constructing Japanese costs. The taxes were extremely nominal compared to what ours are here. I do have that data and I could submit it to you.

Senator STEVENSON. We would like to get it if we could for the record.

[The information follows:]

1974 STEEL INDUSTRY STATEMENT STUDY

[In thousands of dollars]

	Based on published annual reports [1]			
	24-company [2] domestic industry		5-company [3] Japanese industry	
	Dec. 31, 1974	Percent of assets	Mar. 31, 1975	Percent of assets
Balance sheet:				
Cash and equivalent	$3,464,704	12.0	$2,085,440	7.9
Accounts receivable	3,969,014	13.7	2,666,337	10.1
Bad debt reserve	−57,027	−.2	−44,182	−.2
Quick assets	7,376,691	25.5	4,707,595	17.8
Inventory	4,205,513	14.5	4,774,306	18.1
Other current assets	229,269	.8	1,458,845	5.5
Current assets	11,811,473	40.8	10,940,546	41.4
Net plant	14,777,265	51.1	13,092,028	49.6
Other investments	1,594,933	5.5	1,904,836	7.2
Other noncurrent assets	751,496	2.6	423,894	1.6
Total assets	28,935,167	100.0	26,361,304	100.0
Accounts payable	2,482,283	8.6	6,037,138	22.9
Notes payable balk	222,128	.8	1,944,866	7.4
Income and other tax	1,708,337	5.9	223,432	.8
Current maturities	265,794	.9	864,316	3.3
Other current liabilities	1,891,128	6.5	2,852,719	10.8
Current liabilities	6,569,670	22.7	11,922,973	45.2
Long-term debt—one entry	4,642,896	16.0	9,204,300	34.9
Other deferred liabilities	1,892,668	6.5	2,343,326	8.9
Long-term liabilities	6,535,564	22.5	11,947,626	43.8
Total liabilities	13,105,234	45.2	23,470,597	89.0
Total net worth	15,829,931	54.7	2,890,709	11.0
Total liabilities and net worth	23,935,165	100.0	26,361,306	100.0
Net working capital	5,241,803		−982,425	
Current ratio		1.79		0.91
Net quick assets	807,021		−7,215,376	
Quick ratio		1.12		.39
Cash ratio		.52		.17
Tang net worth to debt		1.20		.13
Net KKG CAP to Tang net worth		.33		−.23
Fixed assets to Tang net worth		.93		4.35

See footnotes at end of table.

1974 STEEL INDUSTRY STATEMENT STUDY—CONTINUED

[In thousands of dollars]

	Based on published annual reports[1]			
	24-company[2] domestic industry		5-company[3] Japanese industry	
	Dec. 31, 1974	Percent of assets	Mar. 31, 1975	Percent of assets
	12 months Dec. 31, 1974	Percent of sales	12 months to Mar. 31, 1975	Percent of sales
Income statement:				
Net sales	36,986,248	100.0	20,971,439	100.0
Cost of goods sold	30,664,960	82.9	17,229,549	82.2
Gross operating profit	6,321,288	17.1	3,741,890	17.8
Sales, general and administrative expense	1,839,356	5.0	1,669,894	8.0
Operating profit	4,481,932	12.1	2,071,996	9.8
Other income or gain	461,051	1.2	426,715	2.0
Other expense or loss	410,790	1.1	479,201–	2.3
Income before interest and tax	4,532,193	12.2	2,019,510	9.5
Interest expense	353,484	1.0	1,373,853	6.6
Income before income tax	4,178,709	11.2	645,657	2.9
Income tax	1,780,779	4.8	340,933	1.6
Net profit	2,397,930	6.4	304,724	1.3
Cash dividends declared	642,373		[5] 199,325	
Capital expenditures	2,067,494		NA	
Depreciation—depletion	1,309,844		[6] 1,614,020	
	Percent	Days	Percent	Days
ROI[4]	22.1		16.7	
NP/sales	6.4		1.4	
NP/tang net worth—end	15.1		10.5	
NP/total assets—end	8.2		1.1	
Cash flow/current maturties	13.9		2.2	
Sales/receivables	9.4	38	7.9	46
Sales/inventory	8.7	41	4.3	84
Sales/payables	14.9	24	3.4	107
Sales/net worth	7.0		–21.3	
Sales/tang net worth	2.3		7.2	
Sales/total assets	1.2		.7	

[1] English version of Japanese annual reports.
[2] Alan Wood, Allegheny, Armco, Bethlehem, Carpenter, Copperweld, Colorado, Cyclops, Inland, Interlake, J. & L., Kaiser, Keystone, Laclede, Lukens, McLouth, National, Northwestern, Phoenix, Republic, Sharon, Youngstown, Wheeling-Pgh., and U.S. Steel.
[3] Kawasaki, Kobe, Nippon, Nippon Kokan, and Sumitomo.
[4] ROI=Income before interest and tax/long-term debt plus net worth.
[5] Includes bonuses.
[6] Includes other reserve items.

Note.—$1=293.8¥.

1973 STEEL INDUSTRY STATEMENT STUDY

[Dollars in thousands]

	Based on published annual reports[1]			
	24-company[2] domestic industry		5-company[3] Japanese industry	
	Dec. 31, 1973	Percent of assets	Mar. 31, 1974	Percent of assets
Balance sheet:				
Cash and equivalent	$2,171,769	8.5	$1,930,979	8.5
Accounts receivable	3,100,364	12.1	2,916,919	12.9
Bad-debt reserve	–52,011	–.2	–48,763	–.2
Quick assets	5,220,122	20.4	4,799,135	21.1
Inventory	3,611,372	14.1	3,016,138	13.3
Other current assets	184,395	.7	1,204,901	5.3
Current assets	9,015,889	35.2	9,020,174	39.7
Net plant	14,254,926	55.7	11,865,246	52.2
Other investments	1,830,380	7.2	1,576,172	6.9
Other noncurrent assets	480,499	1.9	250,593	1.1
Total assets	25,581,694	100.0	22,712,185	100.0

See footnotes at end of table.

1973 STEEL INDUSTRY STATEMENT STUDY—CONTINUED

[In thousands of dollars]

	Based on published annual reports [1]			
	24-company [2] domestic industry		5-company [3] Japanese industry	
	Dec. 31, 1973	Percent of assets	Mar. 31, 1974	Percent of assets
Balance sheet—Continued				
Accounts payable	1,811,712	7.1	4,762,180	21.0
Notes payable bank	222,401	.9	1,602,912	7.1
Income and other tax	1,023,625	4.0	146,686	.6
Current maturities	189,231	.7	928,806	4.1
Other current liabilities	1,635,371	6.4	2,214,864	9.8
Current liabilities	4,882,340	19.1	9,655,448	42.6
Long-term debt—one entry	4,955,081	19.4	8,328,980	36.7
Other deferred liabilities	1,747,877	6.8	2,005,520	8.9
Long-term liabilities	6,702,958	26.2	10,334,500	45.5
Total liabilities	11,585,298	45.3	19,989,948	88.1
Total net worth	13,996,396	54.7	2,722,238	12.0
Total liabilities and net worth	25,581,694	100.0	22,712,186	100.0
Net working capital	4,133,549		−635,274	
Currant ratio		1.84		0.93
Net quick assets	337,782		−4,856,313	
Quick ratio		1.06		.49
Cash ratio		.44		.19
Tang net worth to debt		1.20		.12
Net WKG CAP to tang net worth		.29		−.33
Fixed assets to tang net worth		1.01		4.62
	12 Months to Dec. 31, 1973	Percent of sales	12 Months to Mar. 31, 1974	Percent of sale
Income statement:				
Net sales	27,738,323	100.0	16,012,822	100.0
Cost of goods sold	23,585,170	85.0	12,595,659	78.7
Gross operating profit	4,153,153	15.0	3,417,163	21.3
Sales, genrl and admin expense	1,550,720	5.6	1,338,045	8.4
Operating profit	2,602,433	9.4	2,079,118	12.9
Other income or gain	345,011	1.2	292,862	1.8
Other expense or loss	547,128	2.0	681,995	4.1
Income before interest and tax	2,400,316	8.6	1,709,985	10.6
Interest expense	356,760	1.3	1,041,699	6.5
Income before income tax	2,043,556	7.3	668,286	4.1
Income tax	811,816	2.9	280,361	1.8
Net profit	1,231,740	4.4	387,925	2.3
Cash dividends declared	426,678		[5] 200,544	
Capital expenditures	1,371,513		NA	
Depreciation—depletion	1,228,197		[6] 1,556,550	
	Percent	Days	Percent	Days
ROI [4]	12.7		15.5	
NP/sales	4.4		2.4	
NP/tang. net worth–end	8.8		14.2	
NP/total assets–end	4.8		1.7	
Cash flow/current maturities	12.9		2.0	
Sales/receivables	9.0	40	5.5	66
Sales/inventory	7.6	48	5.3	68
Sales/payables	15.3	23	3.3	110
Sales/net wc	6.7		−25.2	
Sales/tang net worth	1.9		5.8	
Sales/total assets	1.0		.7	

[1] English version of Japanese annual reports.
[2] Alan Wood, Allegheny, Armco, Bethlehem, Carpenter, Copperweld, Colorado, Cyclops, Inland, Interlake, J. & L., Kaiser, Keystone, Laclede, Lukens, McLouth, National, Northwestern, Phoenix, Republic, Sharon, Youngstown, Wheeling-Pgh., and U.S. Steel.
[3] Kawasaki, Kobe, Nippon, Nippon Kokan, and Sumitomo.
[4] ROI=Income before interest and tax/long-term debt plus net worth.
[5] Includes bonuses.
[6] Includes other reserve items.

Note.—$1=293.8¥

Senator STEVENSON. I have heard from other sources that profits, however, they are calculated, in Japan are taxed at higher levels than corporate profits in the United States.

Mr. FRANK. But the confusing part, as I see it, is everything seems to be predetermined. Just to mention a point one of the other gentlemen mentioned, allocation of costs, and this is an arbitrary thing. We are talking about what is the cost of producing a ton of steel. A steel company in Japan also produces other products. As an example, they had about $1 billion 3 in nonsteel. But when they allocated the cost to making the nonsteel product, it was $2 billion 7, almost twice the sales dollar amount of the nonsteel items.

So therefore in their approach, when they are looking at total costs, they would be very low, because all of the other costs have shifted over to nonsteel.

This is the confusing part in the accounting system.

Senator STEVENSON. Is the Japanese system unique? Is it the rule, the exception, or what are we to infer from your vivid description of the Japanese system about other countries?

Mr. FRANK. I don't know anything in the world we can compare with the Japanese system. We mentioned different levels or stratas, and they have them all rolled into one, the Government, banking, everything is flexible, and can be called upon and compensated at a later date. The system is so unique that it is impossible to compete against it.

Senator STEVENSON. What do we do? Pick up our marbles and go home?

Mr. FRANK. No, by no means. I think the first suggestion is maybe the General Accounting Office should do a job to determine exactly, with the best information they can gain, how the trading companies work.

Senator STEVENSON. I have tried that, not just through GAO, I have tried it even through our intelligence community, and it is a tough nut.

Mr. FRANK. I have other ideas. But just as an example, from let's say a bystander sitting back, if we pursue in many cases antidumping cases and go on a constructed cost basis, you can do much within the parameters of nontechnology to develop what those costs are. And pursuit in this area and preventing the dumping of products, target products—it started with steel, now fabricating products, down the line. The Japanese, with this targeting, can target any product in the world with their system and do the job.

Senator STEVENSON. Right.

Mr. FRANK. If we go on a constructive cost basis and start spreading this, we have something to negotiate with at a later date, because I think every country in the world has their antidumping laws, and other legislation on the books. They all understand it. And if we say we want fair trade, which would mean free trade, as long as it is fair, I think most of the problems would be eliminated.

Senator STEVENSON. Well, that is saying OK, we won't pick up our marbles if you play the game according to our rules.

Mr. FRANK. Well, they have the same antidumping laws, the Europeans and the Japanese. They are virtually the same.

Senator STEVENSON. You would not favor any American targeting, would you?

Mr. FRANK. I beg your pardon?

Senator STEVENSON. The United States, theoretically at least, could do some targeting, too, with more resources to marshal than the Japanese, and play their game.

Mr. FRANK. Well, just as an example, the Europeans set out their own reference price on steel, about $3 or $4 a ton above ours. We can now sell products there for the first time. Things are boomeranging and new doors are opening.

But just look at the base of what we can do to this economy, and for future export capability. Steel has not been sold, is not down the river now, steel could be a very viable industry. And great threats, if something is not done about it, face this nation. We could have a shortage, if we were to absorb people coming into the work force by the year 2000, we will absorb and consume at least 200 million tons of finished steel product. Today we have 105 million tons of capacity.

The steel industry would have to spend $6 billion a year to partially get that capability in. But the steel industry, aside from the imports, has other constraints. There is no way you could build a Greenfield plant in this country today, because of the ecology laws. Will U.S. Steel build a 4 million ton Greenfield plant in Conneaut, with a capital cost of about $1,600 an annual ton? It has taken them 3 years, I believe, to get the impact studies completed, and if they put this money on the line, and put a 4 million ton plant in, which will take 7 years, they have no assurance that they can operate this plant.

These are some of the constraints. But there are areas where we are cost-effective as it stands now with the Japanese or with anyone. But what industry will be targeted next?

Senator STEVENSON. Well, I know some that are——

Mr. RICHARD HAMMER. Mr. Chairman, could I comment with regard to the point of the Japanese tax system versus the United States?

Senator STEVENSON. Yes, but excuse me, I have to be on the Senate floor at 1 o'clock. So I regret to say I am going to have to leave. But I will ask the staff to wind up this hearing, so we will get any further comments on our record, and maybe the staff, if you have a little bit more time, would have some questions to ask you, too.

If you are going to the comparative tax questions, we would be very interested in that. I do want to say before I leave to the other Mr. Hammer, that we are not neglecting agriculture. In fact, we are devoting a whole day of hearings in Illinois to agriculture very shortly.

Perhaps, though, in my absence you would like to elaborate a little on your suggestions about export subsidies. The production of food in the United States is subsidized and so are the exports. I assume you are not supporting the repeal of Public Law 480, or the discontinuation of CCC credits for exports of agricultural commodities.

With that little provocation, thank you. I have to leave, and will turn this over to counsel.

Mr. RUSSELL. Mr. Hammer.

Mr. RICHARD HAMMER. Although the Japanese statutory rate, when you include both the national tax and the enterprise tax, which are local taxes, it comes up probably slightly higher than the U.S. tax burden, State and local, including the Federal.

Then you find first of all the Japanese have a partially integrated tax system, whereby they reduce the tax on distributed income by 10 percentage points, the national tax.

So you can effectively, if there is a substantial dividend paid to shareholders, around 50 percent, you could ostensibly reduce the effective rate down to the area of 46 or 45 percent.

So it is comparable to ours. When you look at exports alone, item one, they are just about to enact, we think, a subpart (f) equivalent. But our law taxes trade and income, and this will not be covered by their subpart (f). Their subpart (f) will be modeled more after the Canadian foreign property income laws, which only tax passive dividend, royalty and interest income, not trading income. So we have that disadvantage vis-a-vis the Japanese.

In addition, the Japanese have a whole series of deductions and special reserves, in connection with export activities. And it is pretty well laid out in my paper, so I don't have to go into the details. You can establish reserves for overseas market development, a reserve against currency devaluation, things like that.

Finally, and foremost, is the fact that the Japanese enforcement of their intercompany transfer pricing provision, the counterpart of our section 482, has been in a very relaxed atmosphere, with a main thrust of giving benefit to exports.

So, if somehow, I don't have the figures at my fingertips, you could carve out the Japanese tax solely attributable to export income, that is, repatriated, I think you would find it substantially below the U.S. level.

Mr. RUSSELL. Is that something which you feel you could provide?

Mr. RICHARD HAMMER. I am not sure. I could take a crack at it. I think the special committee which I represent could probably come up with some information for you.

Mr. RUSSELL. I am sure the members of the subcommittee would like to have that, if you could provide it.

Mr. RICHARD HAMMER. We would be delighted to take a crack at it.

Mr. RUSSELL. Do any of the other members of the panel wish to comment on the Senator's question about the tax system?

Mr. FRANK. I have here the 1974 statements of 24 domestic companies and 5 Japanese companies. And the tax numbers are rather interesting.

Income tax paid in by U.S. companies—this is 1974—we paid, the 24 companies, $1,718 million for 4.8 percent of our sales in tax. The Japanese paid $341 million, or 1.6 percent of their sales in tax.

Mr. RICHARD HAMMER. That is interesting.

Mr. RUSSELL. Could you tell us the page of your testimony that is on?

Mr. FRANK. I will give it to you right now.

Mr. RUSSELL. There are perhaps one or two other questions that would be helpful to have answered for the record.

Some of the rest of you may have comments on the question of what we can learn from the Japanese trading company example, whether there is any extent to which we could benefit from emulating their performance somewhat by organizing our exports, perhaps modifying our antitrust laws.

Would any of you care to comment on that for the record?

Mr. FRANK. I think it is an ideal concept, but in this country I see great difficulty in having the banks run by the central government or the Federal Reserve, and all of the companies that would be in segregated groups, acquiescing and acting in unison. But the concept is ideal. If you have a group you can put American Motors in, put in a poor textile operation, a poor electronics operation, a marginal steel company, put them into a trading company concept, backed by the U.S. Government, as it is in Japan, they would soon control a fair portion of the industry in the United States. That is how strong they would be.

Mr. MCCLOSKEY. I am accompanied by Mr. Peter Levin, Chairman of our International Business Council. He would like to address himself to that question.

Mr. RUSSELL. That would be fine. Mr. Levin.

Mr. LEVIN. I think that as a starter it is useful to recognize that the Japanese trading companies all have a domestic base. What they do outside of Japan in many respects they also do inside Japan.

And the last time I looked, about 80 percent of their business was inside Japan. That makes one whopping difference in terms of their ability to manipulate what they are doing. They are, of course, internally and externally indirectly in the banking business, they are sometimes directly in the factory business, they are externally of course in the shipping business, they are externally in the manufacturing business in some places.

There are 40 or more functions bound up in a trading company. They do, of course, have the enormous direct relationships with manufacturers whom they represent who may be independent of Japan, but in which the trading company has some kind of ownership.

Now going through all of this, it is more than antitrust that is obviously involved. We have the Federal banking laws, for example, in this country, which simply would not permit such an association.

Mr. RUSSELL. The Agreement Corporation provision, and the Edge Act provisions would provide some possibilities for organization.

Mr. LEVIN. But strictly as an external operation.

Mr. RUSSELL. That is what we would be talking about. I think Senator Stevenson's thought would be this would be strictly for external purposes. I don't think we could change the laws internally.

Mr. LEVIN. Right. On that point, in our industry, particularly, the electronics industries, certainly with respect to the United States, we have found, and we observe that the Japanese trading companies are active for smaller manufacturers, but as soon as the manufacturer has become established here, he sets up his own company, which handle sales, merchandising, marketing and the like, the trading companies in our field, serving the Japanese electronics companies well for the introduction of goods, but the companies themselves, if successful, tend to break away from them.

Mr. RUSSELL. Do other members of the panel have comments?

Mr. RICHARD HAMMER. I don't profess to sanction our laying down the arm's length principle. I think we are too far along the road for that. And we are a member of OECD, and all of those bodies do sanction arm's length pricing. I think the Japanese to some extent tend to deviate from the true arm's length principle in furtherance of exports, so there will be more profit shifted abroad and make it attractive.

So I have to come back to something Mr. McCloskey hit home hard on, that our DISC concept today is probably the best weapon we have to counter the Japanese trading company threat, in that it does give us the wherewithal—as you know, the DISC provides for safe haven intercompany transfer application rules, without any relationship to the arm's length principle.

As long as it is a deferral and doesn't meet the GATT concepts of a subsidy, which we don't think it does, nor does the special committee think it does, nor many other people who have considered it, I think it is our best weapon until something can be done in multinational trade negotiations.

I may be wrong, but I believe that the Japanese did not agree to the subsidy provision of GATT. I suspect—I don't know if any of you gentlemen know that or not. It is my recollection that I read that somewhere. So they are, with impunity, I suspect, they could flout the GATT rules on export pricing. I won't say they have done it with impunity, but they have been given the wherewithal to their exporters by not pressing as hard on the arm's length principle as we do.

I think that is something we can only counter, not by taking our emphasis off the arm's length principle, but make it even better, if possible.

Mr. RUSSELL. Since you have come back to that question, I believe Senator Stevenson wanted to ask you about the tax incentives that go beyond what you responded earlier. The DISC and other tax incentives may provide some stimulus to exports—we are going to have other hearings in the Congress on that shortly—but I think we were looking at the possibilities that might really do something for small, perhaps medium-sized industry, to get industries into the exporting business that weren't in exporting before. The term "targeting" was used. Perhaps picking industrial sectors where we have the future possibilities of export growth. I don't know if a tax system is the way to do that or not, but that is one of the thoughts on the mind of Senator Stevenson. That wouldn't necessarily mean DISC, would it? You may need a modified DISC, maybe you need some other tax incentives.

Mr. RICHARD HAMMER. I have thought about this question a long time, because really if the thrust was to encourage smaller companies, the use of DISC would be a unique way to do it, or ideal way to do it, but removing the overall, overriding provision that was in the original DISC legislation.

In other words, the original DISC legislation was a compromise between the Senate and the House and the Administration at that time, in 1971. It came out no incremental at that time which was suggested by the House, I think, or somebody, with a 50-50 split, half the export income would be tax-deferred.

Now the ideal way to assist small companies would be to make a 100-percent loaf instead of a 50-percent loaf, through the tax system.

You know, there is no guarantee the tax system is the best way, the only way. I happen to think it probably does work well to insent imports. You give them a 100-percent DISC and I think you would find a great incentive for exports that doesn't exist now.

When you take the 1976 legislation, impacted on top of the original legislation with an incremental rule, that to mind really takes the whole DISC benefit away from the large companies to a large extent, and puts it back on new exporters, small exporters, people just getting into the field for the first time or building up their export business.

Because the incremental rules phase-in for an 8-year period. I am not in favor of the incremental rules personally.

First of all, it is not worth the effort, it is too complicated. But there are other possibilities in the tax law, if you want to emulate the Japanese, to provide for various reserves, reserves for market losses, reserves for currency changes.

But my own feeling is this runs anathema to the basic U.S. tax philosophy of not recognizing deductions until all events have occurred, and the deduction or expense has been accrued and spent. But nonetheless, consideration could well be given to the possibility of various types of reserves to enable perhaps newer companies, smaller companies, to at least embark upon export activities for the first time.

So I think there is probably a lot of things that could be done, maybe we should take some lessons from our trading partners to some extent, as they do from us. They pick up some of our bad things unfortunately.

Mr. Russell. Do any of you other gentlemen have thoughts on the incentives that might be targeted for smaller businesses to get into the exporting business that you haven't covered?

[No response]

Mr. Russell. Well, thank you very much. I think we have covered it. If you have additional thoughts for the record, the committee would like to receive them.

[Thereupon, at 1:15 p.m. the hearing was concluded.]

[Additional material received for the record follows:]

Allied Chemical

Corporate Headquarters
P.O. Box 1057R
Morristown, New Jersey 07960

March 31, 1978

The Honorable Adlai E. Stevenson, III
Chairman, Subcommittee on
International Finance
Senate Banking, Housing and Urban
Affairs Committee
Washington, DC 20510

Dear Mr. Chairman:

Allied Chemical Corporation strongly supports Congressional inquiries into the effectiveness of export performance and policies. One of the foremost factors changing the economic structure and relationships in the international chemical industry is the increased involvement by governments of other nations in the ownership and operation of these businesses. Such intervention can place the U.S. industry in a position where it is unable to effectively compete. We would like to illustrate three general types of anti-competitive foreign government subsidy present in international trade today.

Unfair Pricing

First, the impact of outright government operation of a nationalized chemical company is exemplified by examining the petrochemical industry in Venezuela: the Instituto Venezolano de Petroquimica (IVP). IVP is the publicly-owned petrochemical organization responsible for conversion of natural gas into chemical derivatives, ranging from fertilizers and plastic materials to ethylene, propylene and other feedstocks for further processing. As IVP developes these feedstocks to the level where they can supply a subsidiary industry, new plants are constructed and companies formed for production of a dozen or more industrial products. Each of these subsidiary companies is partially-owned by IVP, with investment running anywhere from wholly-owned to as low as 15%.

As you know, government-controlled companies and their subsidiaries operate substantially differently from private enterprise. Petroleum feedstocks, for instance, are transferred at low values which U.S. operations could not afford. We are experiencing, for example, a recurring problem with low-priced imports of phthalic anhydride from IVP's Oxidaciones Organicas, C.A. (OXIDOR). These prices were sufficiently low for industry to consider anti-dumping measures against IVP. However, we felt that international and domestic institutions for handling these unfair trade practices appear to be inadequate due to the lack of data that can be obtained in the home country concerning these government-owned industries. The issue is further compounded because of the difference between U.S. and Venezuelan accounting methods, data retention and concepts of investment criteria. After lengthy study and review of these problems, we at Allied Chemical felt that actions under present countervailing duty provisions would be difficult to initiate and support.

Loss Subsidy

A second example of foreign government intervention in the chemical industry, government underwriting of losses, is Montedison -- Italy's government-controlled chemical corporation. A brief summary of their sales, earnings and capital expenditures, as shown below, illustrates that they -- unlike U.S. industry -- are not constrained by the need to earn a profit.

	Sales (Billion/Lire)	Earnings (Billion/Lire)	Capital Expenditures (Billion/Lire)
1971	625	195 Loss	90*
1972	823	458 Loss	326
1973	1183	6	271
1974	2300	81	138
1975	1890	73 Loss	278
5 Yr. Total	6821	639 Loss	1103

1977 Deficit: $594.5 Million

An observer could conclude that, because of government subsidies, Montedison can continue capital expansion in the face of extensive losses.

Export Subsidy

A third example of government intervention which adversely affects the U.S. chemical industry is taking place just over the border, in Mexico. Hydrofluoric acid is exported by Quimica Fluor in Matamoros, Mexico, under export certificates, or CEDI's (Certificados de Devolucion de Impuestos Indirectos; i.e., Certificates for Return of Indirect Taxes) with a value of about 12 to 14 percent of net realization. If Quimica Fluor nets $550 per ton, it would receive CEDI's valued at $66 per net ton.

*Estimated from change in gross fixed plant assets

These CEDI's can be used to pay corporate taxes or income taxes or can be returned to the government for cash redemption. They are, therefore, equivalent to a tax credit in their effect on cash flow and after-tax benefits, as opposed to pre-tax benefits of lower manufacturing cost. In fact, given the 48% U.S. corporate tax rate, this $66/net ton is equivalent to approximately $115 pre-tax (dollars).

Such benefits, bestowed by foreign governments provide practically any reasonably well managed foreign operation with an unfair advantage in competing with U.S. operations.

We hope the hearings this Committee is conducting will serve as a basis for legislation to improve the competitive position of U.S. industry in world export markets. Otherwise, the stagnant export situation, recently analyzed by the U.S. Department of Commerce (Trends in Chemical Exports 1970-1976, June 1977), will continue to worsen. The U.S. chemical trade surplus will continue to be reduced and even eliminated if methods are not provided to place the U.S. chemical industry on a competitive basis worldwide. We thank you, Mr. Chairman and Members of the Subcommittee, for this opportunity to share our views with you. If we can be of any further assistance to you on this matter, please do not hesitate to call on us.

Respectfully submitted,

George M. Swartzwelder

George M. Swartzwelder
Coordinator, Trade Act Issues

GMS/vmk

BEDELL ASSOCIATES,
Washington, D.C., March 23, 1978.

Hon. ADLAI STEVENSON,
Chairman, Subcommittee on International Finance, Committee on International Relations, Russell Senate Building, Washington, D.C.

DEAR MR. CHAIRMAN: In connection with your "comprehensive study of U. S. export performance and export policy," on behalf of Diamond/Sunsweet, Inc., a major marketer of dried fruit and tree nuts, we believe your Subcommittee will be interested in a description of certain export subsidies applied by the European Economic Community, and their impact on U.S. exports to 3rd countries.

In addition to illegal restrictions imposed by the EEC on exports of U. S. specialty crops, the EEC maintains export subsidies on an extensive list of specialty agricultural crops. The list includes apples, shelled almonds, tomatoes, fresh lemons and table grapes, in addition to walnuts of which Diamond/Sunsweet, Inc. is the largest single industry factor. Walnut exports totalled about 76,000,000 pounds in crop year 1977, or approximately $45,000,000.

EEC Regulation 2791/75 established certain subsidies and raised others, and became effective October, 1975. The subsidy for walnuts rose from 8 UA to 10 UA/100 kilograms (1 UA is termed a Unit of Account, and is presently valued at $1.25), or a subsidy of 5.7¢/pound.

From the point of view of the walnut marketer abroad, such a subsidy by the EEC is unnecessary and irrational, on 2 counts.

First, the EEC (France) at best grows no more than 50% of annual consumption, in the best of years. In poor crop years, E. G. 1976. French production was less than 20% the annual average which is about 35%.

Second, the total amount exported in good years is insufficient to acquire any meaningful foreign exchange or affect the trade balance. But it has the potential to disrupt the pricing and delivery of product in a given year to a given country, as for example Norway and Sweden in 1974, the last good French walnut producing year.

These predatory pricing practices do not cause serious damage, at the present rate of production. They do, however, cause loss in the country or countries in question, and provide cause for alarm in the future should volumes increase. They are clearly illegal under GATT in any case, in addition to failing to explain the manoeuvre's purpose.

This same pattern is followed by the EEC in apples and pears, especially in Latin American markets. All this is of course in addition to a long history of EEC restrictive trade practices on imports of apples and pears from the U.S., with the devastating impact as described by Assistant Secretary Dale Hathaway in his testimony on February 23, 1978.

We feel that a far stronger STR and State Department position on these types of subsidies for their elimination not only by themselves but in conjunction with illegal import trade restriction is absolutely necessary for the protection of U. S. export markets abroad. Unless our government musters the necessary courage to support open access to foreign markets, many U. S. companies will eventually cease to accommodate those markets except as surplus markets (some already do). For those who worry about international balance of payments for the U. S. such a development continuing will make solutions harder.

We earnestly hope your present series of hearings are sufficiently timely to have a truly trade liberalization impact on the MTN negotiations which must increasingly must deal with growing illegal and unfair import restrictions of foreign countries toward U. S. exports.

We look forward to your May hearings regarding such foreign import restrictions. Meanwhile we hope this letter can be made a part of the Subcommittee record.

Very truly yours,

DONALD W. BEDELL.

27-039 O - 78 - 19

POLICY AND BUDGET OPTIONS FOR INTERNATIONAL ECONOMIC RECOVERY

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This paper was written while the author was Deputy Assistant Director for International Affairs of the U.S. Congressional Budget Office. The views expressed herein are those of the author and do not necessarily reflect those of the Congressional Budget Office.

CONTENTS

SUMMARY

THE PROBLEM

The international economy currently faces a major unresolved problem: the maintenance of economic activity at an adequate level.

The proximate cause of the contractionary pressure on the world economy was the quadrupling of oil prices in 1973. The ensuing, roughly $45 billion, persistent annual current account surplus of a few of the OPEC countries has depressed world demand. Had the "oil tax" not been imposed, these sums would have been part of demand and spending in the oil-importing countries.

This contractionary pressure caused by the shortfall in demand resulting from the "oil tax" can be offset for the oil-consuming countries _taken as a group_ only by some mix of the following:

- o borrowings sufficient to finance the amount of imports needed to maintain pre-oil-tax levels of world consumption and investment;
- o domestic structural adjustment policies which will gradually reduce the OPEC surplus to a level consistent with available financing;
- o or long-term inflows of direct investment capital from surplus countries to deficit countries.

Thus far, the burden of a solution to the contractionary pressures on the world economy has been, and continues to be, largely placed on the financial markets. As long as OPEC and other countries have a persistent, aggregate current-account surplus, still other countries must have and finance a counterbalancing deficit. Only when oil-importing countries move to a lower level of oil consumption, or when the OPEC (and other) surplus countries are ready to accept payment for their oil (or other exports) in real goods and services, or in the form of long-term investments, can the spiral of increasing debt cease without contractionary consequences.

More than half of the deficits currently being run by oil-importing countries are being financed by private capital markets, but private financing is limited by lenders' perceptions of a lack of "creditworthiness" of many potential borrowers. Many uncreditworthy countries, only some of which belong to the group of less developed countries (LDCs), are "solving" their inability to maintain their imports by reducing their own growth rates. This contributes not only to possible internal political strain, but also to lower growth rates for the "stronger," more resilient advanced countries. Imports foregone by "uncreditworthy" countries are exports (and thus economic growth) foregone by the United States and other nations.

Because "uncreditworthiness" often arises from stubborn structural problems of deficit countries, it is likely to persist for some time. Thus, public financing, intermediation, guarantees, or other interventions in financial markets may be necessary to bridge the gap between the financing needed to maintain imports and the willingness of commercial lenders to bear the risk of providing that financing.

"CURRENT POLICY"

A minimal choice open to the United States would be to simply avoid taking measures in bank regulation and tax reform which might reduce the flow of private financial resources to foreign countries.

This "current policy" option, however, would imply the acceptance by the United States of the risk of low worldwide growth rates, and of the risk of adverse political strains in countries obliged to reduced growth.

ALTERNATIVE OPTIONS

The United States arguably has an interest in increasing the capacity of "uncreditworthy" countries to import. Several alternative options for supporting international financial flows exist; four that may be considered are the following:

- An expansion of on-budget, non-military U.S. foreign assistance and credit programs, either through increased appropriations or through debt relief.
- A "private sector"-oriented option, with the U.S. government playing a role of guarantor or financial intermediator.

- o The Ford Administration's proposed OECD Financial Support Fund or "Safety Net."
- o An expanded International Monetary Fund, including possible revival of the Oil Facility.

Option 1: Increased Budget Authority and Outlays for U.S. Non-Military Foreign Assistance and Credit Programs

The Congress could appropriate increased budget authority for on-budget foreign assistance and credit programs. The United States has full control over bilateral programs and could therefore target foreign assistance to countries either most likely to spend incremental funds on imports of goods and services or most in need of financing to avoid the social strains of attempts at over-rapid adjustment to a capacity-to-import, or debt-service constraint. (Such control would be more diluted in the case of increased contributions to multilateral development banks /MDBs/ where the United States has only the "influence" accruing to a major shareholder.)

Increasing foreign assistance or credits could also have drawbacks as a policy for world stimulus and stabilization. For example, most existing foreign assistance and Export-Import Bank credit programs "spend out" on real goods and services at an exceedingly slow rate.

Debt Relief. Rescheduling or cancelling some debt service payments due to U.S. government agencies from deficit, debtor countries would immediately increase the capacity to import of debtor countries. In fiscal year 1977, foreign debt service payments (on non-military accounts) to the U.S. government are expected to total some $3.2 billion. The majority of these repayments are to be made by non-oil LDCs.

No convincing case has been made, however, that all LDC or weaker OECD economies would immediately use funds freed by the suspension of debt repayments on imports to increase imports, much less to increase imports for investments aimed at adjusting to a world of high oil prices. Thus, a generalized moratorium, such as that requested by some LDC members of The United Nations Conference on Trade and Development (UNCTAD), may not be the most appropriate tool for international economic stimulus.

Option 2: Guarantees for Private Sector Financing

The U.S. government could also expand the guarantee and insurance programs of the Export-Import Bank, the Overseas Private Investment Corporation (OPIC), or of other U.S. or multilateral institutions, of private loans and investments. Callable capital guarantees could also be increased for backing multilateral development bank (MDB) borrowing from the private sector.

Offering the private sector an increase in the amount of guarantees available would provide no necessary assurance that those guarantees would be used. It is more certain that MDB callable capital would lead to increased MDB borrowing. However, increased MDB borrowing based on callable capital would almost certainly "spend out" or loan out to LDC borrowers at a very slow rate.

Guarantees of private sector financing of deficit countries have been criticized as a potential "bail-out" of private commercial banks and lenders. A counter to this criticism is that guarantees which do not lead to outlays--or which outlay only in extraordinary circumstances--are much less costly of taxpayers' money (if not less costly in terms of resources diverted from the domestic economy) than are foreign assistance loans or grants.

Option 3: The OECD Financial Support Fund (or "Safety Net")

In June of 1975, the Ford Administration sent to the Congress a proposal for the establishment of a Financial Support Fund (FSF) which would have a membership limited to the 25 OECD member countries. As initially proposed, the FSF would have a total subscribed capital of $25 million. The U.S. share of the FSF was proposed at some $7 billion.

As its nickname of "Safety Net" implies, the FSF was conceived as a means to cope with the problem of stabilization, not that of stimulus.

As an off-budget fund, to be financed only under a U.S. guarantee (except in the extreme case of borrower default), the FSF would not be expected to require budgetary outlays and would, therefore, not have the impact on the federal deficit that an expansion of on-budget loans or assistance programs would have.

The FSF proposal has been criticized on the grounds that it would not provide financing to some of the countries likely to have the greatest need, the middle- and lower-income, non-oil LDCs.

Option 4: An Expansion of the International Monetary Fund

The difficulty of predicting which debtor countries may face sudden credit crises suggests that the most pressing needs may be for a flexible, normally revolving fund which would operate to fill the gap between national and international, short-term monetary instruments (like the Treasury Department's Exchange Stabilization Fund and Federal Reserve Swap Loans) and long-term development instruments, such as foreign assistance and private investment. Since the IMF--an organization which includes LDCs--already performs many of the functions which might be required of such a fund, the requisite instrument could simply be an expanded IMF.

Such a fund might be called upon to lend rather large amounts of money on a medium-term, one-to-five-year basis. In 1976, Mexico borrowed $962 million from the IMF. Four such incidents would require an IMF with double the present size of the IMF's resources of available and uncommitted currencies. An IMF with a capability to finance an increase of 2 percent in (non-communist) world trade would need some $17 billion in incremental resources in 1977.

The resources of the IMF could be augmented by an increase in members' quotas or by the re-creation of a temporary arrangement similar to the now-defunct Oil Facility.* A permanent increase in Fund resources would be brought about by a review and increase in the quotas of the member nations. A temporary facility could obtain funds from surplus countries and loan them for medium-period terms to the deficit countries experiencing a capacity-to-import constraint to growth.

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* In 1974 and 1975, immediately following the quadrupling of oil prices, the IMF ran a so-called "Oil Facility" that acted as a direct intermediary between OPEC and industrialized countries and current borrowers (such as the United Kingdom, Italy, and Spain). During the two years of its existence, the OPEC countries provided nearly $6 billion and the "strong" surplus industrialized countries provided some $2 billion in resources to the Oil Facility for five- to seven-year terms at a rate of 7 percent interest. The resources were lent to borrowers--without conditionality--for terms of five to seven years at just over 7 percent interest. Access to the Facility was based on the degree to which a borrowing country's bills for oil imports had increased. The Oil Facility is currently inoperative. It is alleged that it became defunct because the interest rates it was offering became unattractive to OPEC leaders. Apparently, the reluctance of certain developed, industrial countries to see "too much OPEC influence" in the IMF also contributed to the demise of the Oil Facility.

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The review and negotiation of quotas is a time-consuming process. To meet the perceived need for a temporary increase in Fund resources, the Executive Directors of the Fund established, in August 1977, a Supplementary Financing Facility. This new facility, more commonly called the Witteveen Facility, will provide an additional 8.7 billion in Special Drawing Rights (SDR)--about $10.5 billion--to the resources of the IMF. Resources made available for the Witteveen Facility will be lent to the IMF. The IMF, in turn, will lend them to member countries in need of balance of payments financing. Use of the facility will be open to all Fund members. The maturity of loans extended by the facility will be from three to seven years.

U.S. participation in the facility would involve making available to the IMF the dollar equivalent of 1.45 billion SDRs (about $1.75 billion). The IMF would draw upon these funds, if and when needed, to meet drawings by member countries from the facility. Funds actually drawn by the IMF will earn interest at a rate equal to the yield on U.S. Treasury securities of comparable maturity. In exchange for funds provided to the facility, the U.S. will receive a reserve claim on the IMF, which may be redeemed upon the demonstration of balance of payments need or may be sold to other members of the IMF. U.S. participation in the Supplementary Facility would require authorization by the U.S. Congress. It is uncertain whether participation would be subject to the appropriations process.

CHAPTER I. THE PROBLEM

The international economy currently faces a major unresolved problem. It is not the overall indebtedness of oil-importing countries taken as a group, even though some individual banks, lending institutions, and borrowing countries may find themselves occasionally "overexposed." The world's economy's problem is one of the maintenance of economic activity at an adequate level. During the 1960s and early 1970s, most countries became accustomed to a relatively smooth process of economic growth. Since 1973, however, many countries have had difficulty in fulfilling the aspirations of their people. Only Germany, Japan, and a few of the less developed countries (LDCs)--those with higher per capita incomes--appear to be satisfied with either their recent or prospective rates of growth. 1/

The proximate cause of the contractionary pressure on the world economy was the quadrupling of oil prices in 1973. The ensuing, roughly $45 billion, persistent annual current-account surplus of a few of the OPEC countries has depressed world demand. 2/ Had the "oil tax" not been imposed, these sums would have been part of demand and spending in the oil-importing countries.

1/ Organization for Economic Cooperation and Development (OECD), Economic Outlook (December 1977), pp. 3-7 and 13-26.

2/ "The International Economy and the Federal Budget," Committee on the Budget, U.S. Senate, Committee Print (December 30, 1976).

This contractionary pressure caused by the shortfall in demand resulting from the "oil tax" can be offset for the oil-importing countries <u>taken as a group</u> only by some mix of the following:

- borrowing sufficient to (and distributed among countries in such a way as to) finance the amount of imports needed to maintain "pre-oil-tax," desired <u>levels</u> (if not necessarily the kinds or exact country distribution) of world consumption and investment;
- domestic structural adjustment policies which will gradually reduce the OPEC surplus to a level consistent with available financing--either by increasing export sales to OPEC countries or by pursuing energy conservation or substitution policies which will reduce consumer countries' demand for OPEC oil; or by
- long-term inflows of direct investment capital from surplus countries to deficit countries, and the use of such investment by oil importers in such a way as to "bridge" this time gap between current consumption and investment patterns and future energy-conserving (or OPEC-developing) structural needs.*

As a result of political and social constraints, domestic structural adjustment policies have, however, proved to be difficult to effect in many oil-importing countries; even the United States is only now beginning to consider a major energy conservation and substitution effort. Neither the OPEC surplus countries nor the other countries--such as Germany and Japan--which are running current-account surpluses have provided significant

* Robert Solomon of the Brookings Institution has put the point compactly as follows:

> By almost perfect analogy with the Keynesian saving-investment process in a closed economy, one can argue that <u>ex ante</u> deficits on current account must equal <u>ex ante</u> surpluses if a high level of world income is to be maintained. As long as OPEC, Germany, and Japan are unable to reduce their <u>ex ante</u> surpluses, either other countries must incur current account deficits or world income will fall until <u>ex post</u> surpluses and deficits are equated.

long-term investment capital to deficit countries, compared to their large current-account surpluses.[3/] OPEC, Germany and Japan have declined or been unable to reduce their large current-account surpluses by importing more, and thereby stimulating others' exports and income. Consequently, the burden of a solution to the contractionary pressures on the world economy has been largely placed on the financial markets and organizations which can provide the funds needed by borrowers to maintain the imports necessary for their--and exporters'--growth.

As long as OPEC and other countries maintain a persistent, aggregate current-account surplus, still other countries must have a counterbalancing deficit. As long as OPEC, Germany, and Japan accumulate surplus funds, other countries must incur increasing amounts of indebtedness if world economic activity is to be sustained. Only when oil-importing countries move to a lower level of oil consumption by domestic conservation or substitution measures, or when the OPEC (or other) surplus countries are ready to accept payment for their oil (or other exports) in real goods and services, or in the form of long-term investments, can the spiral of increasing debt cease without contractionary consequences. If structural constraints prevent OPEC, Germany, and Japan from increasing spending on imports, if financing for deficit countries is not available, and if adjustment is not complete, the OPEC (and other) surpluses will be brought down to a level consistent with the available financing by some countries' reduced growth.

More than half of the net resources currently being transferred to developing countries by OPEC countries and developed nations are in fact

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3/ International Monetary Fund (IMF), Balance of Payments Yearbook, various country pages.

being financed by private capital markets,[4/] but private financing is available only to a limited number of developed countries and upper-income LDC's, and at a level which is limited by lenders' perceptions of a lack of "creditworthiness" of many potential borrowers. It is the "uncreditworthy," politically and socially fragile countries which are unable to obtain private financing for imports at levels consistent either with a politically acceptable rate of growth for themselves, or with acceptable rates of growth for the international economy as a whole. These uncreditworthy countries are "solving" their inability to maintain their imports at desired levels through recourse to public lending institutions, through economic stagnation, or through a combination of the two.

The pressure to reduce imports and growth has been strongest on the poorest countries (those with per capita incomes of less than $200 per year). The Joint Development Committee of the IMF and the World Bank asserts that these countries have maintained debt-service-to-export ratios at reasonable levels since 1973 only be a 20 percent reduction in their import values (in real terms) below levels experienced in the late 1960s. These same countries have had virtually no growth in per captia income since 1970.[5/] The fact that even some countries are obliged to "solve" their inability to finance desired imports by reducing their own growth rates is a force contributing not only to possible political strain for themselves, but also to lower growth rates for the "stronger," more resilient, advanced countries.

4/ Derived from Tables 1 and 2, pp. 8-9, U.S. Treasury, Report on Developing Countries External Debt and Debt Relief Provided by the United States (January, 1977).

5/ See IMF-World Bank Development Committee, Communique, October 3, 1976.

Imports foregone by "uncreditworthy" countries are exports foregone by the United States and other nations. In 1976, exports of goods and services accounted for nearly $115 billion, an amount equal to some 10 percent of U.S. aggregate demand.[6/] Exports of goods and services accounted for 20 percent or more of aggregate demand of most other OECD countries.[7/] A failure of this component of aggregate demand to grow will lead to lower overall growth unless this failure is offset by structural adjustment measures. Estimates made with a large-scale econometric model at the Wharton School of the University of Pennsylvania (the "LINK" model) suggest that, other things being equal (such as a reluctance or inability by OECD countries to stimulate their economies by increased government spending), a reduction of 3 percentage points in the annual growth rates of the non-oil LDCs alone (of the sort expected by the United Nations for the rest of the decade) is likely to reduce the annual growth of the OECD economies (taken as a group) by 1 percentage point.[8/]

OPEC alone cannot be blamed for the fact that particular, uncreditworthy countries are unable to obtain either enough

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6/ U.S. Department of Commerce, Survey of Current Business (May 1977).

7/ Wolfgang Hager, Europe's Economic Security, The Atlantic Papers, 3/1975, The Atlantic Institute for International Affairs, (Paris 1976), p. 22.

8/ UNCTAD, Trade Prospects and Capital Needs of Developing Countries, 1976, United Nations, TD/B/C.3/134, (April 15, 1976), p. 39.

short-term financing or long-term capital to allow real imports to be maintained and domestic adjustment to take place gradually, as a politically tolerable pace. The social and economic rigidities of many deficit countries--such as the United Kingdom, Italy, Portugal and many LDCs--largely antedate OPEC's quadrupling of the price of oil and, for that matter, the nearly simultaneous tripling of the grain prices paid by these countries, most of whom are dependent on imports of food.

Because these rigidities are well entrenched, they will probably take some time to overcome, and any improvements in "creditworthiness" may also be delayed. Thus, public financing, intermediation, guarantees, or other interventions in financial markets may be necessary to bridge the gap between the financing needed to maintain imports and the willingness of commercial lenders to bear the risk of providing that financing. Otherwise, there is some risk that still more oil-importing, deficit countries will soon find that they can neither borrow enough in private markets to maintain growth, nor borrow enough to allow domestic adjustment to proceed at a politically acceptable pace. There is also a risk that, if they cannot borrow or adjust at prevailing exchange rates, they may try to export their adjustment problems to others by competitive devaluations or by renewed attempts to form exporters' cartels to raise export prices.

Some public financing has already been made available to both developed and less developed deficit countries--principally on the basis of feared political strain, rather than on the basis

27-039 O - 78 - 20

of a desire to raise capacities to import. During the past year, the United Kingdom and Italy borrowed massively from the International Monetary Fund (IMF) and from various OECD governments (including the United States); Portugal obtained over $600 million in assistance from several European governments and multilateral institutions and has sought funds from the United States; and Mexico needed nearly $1 billion in emergency support from the IMF.[9/] Without this support, it is doubtful that these countries could have maintained their economic activity at a level sufficient to avoid fundamental political and social dislocations. Egypt showed by example that riots could result from a too rapid try at cutting internal consumption to a level consistent with available financing for imports.

More public financing or intervention in credit markets may prove necessary. Massive general default or rescheduling of the debt accumulated by oil-importing countries is not imminent at this time. World Bank data show that abnormally high debt-service-to-export ratios (those in excess of 10 percent) are concentrated among 21 of the 86 LDCs and "more advanced" Mediterranean coun-

9/ Robert J. Samuelson, "South of the Border," National Journal (February 26, 1977), p. 325.

tries. Only 12 countries had debt-service ratios exceeding 15 percent.[10/] However, since these countries, and others whose identities may not be easily predictable in advance, may face liquidity--or political difficulties--it is appropriate to consider the international policy instruments available to the United States for coping with such potential crises, as well as for improving the prospects for the health of the world economy.

10/ World Bank, Annual Report, 1976, pp. 104-105. These 12 countries were Israel, India, Pakistan, Egypt, Afghanistan, Uruguay, Peru, Panama, Mexico, Colombia, Brazil, and Argentina. Incomplete data for 1975 indicate that Sri Lanka also came to have a debt-service ratio exceeding 15 percent. Debt-service ratios are not the only, or best predictors of reschedulings. More sophisticated analyses suggest that the likelihood of international debt reschedulings over the next five years is lower than the simple debt service ratios might suggest. (See: Alice L. Mayo and Anthony G. Barrett, "An Early Warning Model for Assessing Developing Country Risk," in Export-Import Bank of the U.S.," Financing and Risk in Developing Countries, August, 1977.)

CHAPTER II. POLICY AND BUDGET OPTIONS

U.S. INTERNATIONAL PROGRAMS

The United States already has, or supports, 21 major bilateral and multi lateral loan, grant, tax, or guarantee programs which collectively play a major role in underpinning financial flows to foreign countries.[1/] Guarantee, tax, and off-budget programs each provide roughly the same level of support as does the $6.5 billion level of net outlays included in on-budget, foreign assistance, credit, or spending programs.

The great majority of this more than $25 billion annual net flow of financial resources (that in some way involves the U.S. government) goes to less developed countries and to U.S. military allies, including developed countries such as the United Kingdom and Italy. More than half of this flow of resources can be identified with more or less certainty as going to non-oil LDCs. U.S. and multi-lateral programs are somewhat less directed to the less advanced OECD countries.

1/ These programs are listed in the Annex. The Annex also shows the net outlays expected of these programs during fiscal year 1977 (or other indicators of program size), along with a geographical breakdown of foreign beneficiaries, classified as "strong" OECD [Germany and Japan], other OECD, and non-oil LDC countries.

Existing policy instruments tend to be either on-budget and focused primarily on very long-term objectives (such as economic development or Eximbank facilitation of U.S. capital goods exports) or off-budget and focused on very short-term, three-to-six-month crisis management (the Treasury Department's Exchange Stabilization Fund and the Federal Reserve Swap Loans). Public provision of medium-term lending appears to be the nearly exclusive province of off-budget, multi lateral institutions or arrangements--such as the International Monetary Fund--which the United States does not directly control. The only on-budget U.S. program to have been used for purposes of medium-term economic stabilization of foreign economies has been Security Supporting Assistance (SA). (Congress has authorized a special, on-budget, medium-term loan of $300 million for Portugal for fiscal year 1978.)[2/] SA has, however, gone only to a handful of countries in which the United States has had a pressing political interest.[3/]

"CURRENT POLICY"

One choice open to the United States in dealing with current international economic problems would be to simply avoid taking measures that might reduce the flow of financial resources to foreign countries. Under such an option, the U.S. government

2/ International Security Assistance Act, P.L. 95-92.

3/ Congressional Budget Office, Budget Issue Paper, Bilateral Development Assistance: Background and Options, (February 1977), p. 11.

would avoid imposing accounting rules on private banks that would require them to write off rescheduled debt on their profit and loss statements. Current accounting rules do not require banks to write off rescheduled repayments of principal. As long as such rules remain in effect, most short-term liquidity "crises" can be treated in a relatively discreet manner and can be contained so as not to impair "confidence."

The U.S. government would also avoid taking measures such as eliminating the provisions of the Internal Revenue Code that allow deferral of taxes on foreign sources of income as long as it is not remitted to the United States, and a credit for foreign taxes paid. These tax provisions make foreign investment more attractive for U.S. firms than would otherwise be the case.

A "current policy" option would imply only limited U.S. support for the level of international economic activity and, therefore, the acceptance of the risk of low worldwide growth rates. It would imply an acceptance of reduced export growth for the United States and its allies and, thus, an acceptance of lower overall U.S.--and NATO--economic growth or of more use of domestic stimulus measures, such as deficit spending (which, in the absence of rapid structural adjustment, may be more successful at producing inflation than real growth). It would be an option that would be difficult to reconcile with a combined target of a balanced domestic budget and full employment by 1981. Since such an option would in and of itself neither increase U.S. government spending nor lead to the creation of any monetary assets, however, it would create no inflationary pressures in the U.S.

"Current policy" was evidently insufficient to prevent a crisis of over-rapid adjustment to a capacity-to-import constraint in Egypt. It may or may not have been fully adequate in the cases of Portugal and Italy. Consequently, this policy would imply the acceptance of some risk of additional crises.

POLICY CHANGE

U.S. policy should be altered in the interest of either stimulating the world economy or of preventing the tensions of over-rapid adjustment, or both, if the U.S. judges that existing institutions or programs are not large enough either to promote growth or stability, or that existing instruments are "badly targeted" (i.e., promote or safeguard a flow of financial resources to countries in no risk of crisis or experiencing no financial constraint on their imports).

If the United States is interested in insuring against political crisis and in promoting world economic growth, it arguably has an interest in increasing "uncreditworthy" countries' capacities to import. The United States probably does not have an interest, however, in supporting measures to simply increase the flow of finance to all countries. Japan and Germany have trade-balance surpluses and are themselves rapidly accumulating reserves. Clearly, countries such as these are not experiencing reduced growth due to constraints on their capacity to import. Rather, they are contributing to the problems of other countries. Even some less developed countries are currently increasing their holdings of foreign exchange reserves, rather than spending their foreign exchange earnings on imports of real goods and services.[4/] An increased flow of financial resources--public or private--would provide more stimulus to the world economy if it went to countries that would be more likely to spend rather than save.

Among the options of merit are the following:

- An expansion of the on-budget, non-military U.S. foreign assistance and credit programs, either unilaterally or in cooperation with other "strong" OECD or OPEC countries.
- A "private sector"-oriented option, with the U.S. government playing the role of guarantor or financial intermediator.
- The Ford Administration's proposed OECD Financial Support Fund or "Safety Net."
- An expanded International Monetary Fund, including possible revival of the Oil Facility.

4/ International Monetary Fund, International Financial Statistics, (various country maps) (August 31, 1977) and World Bank staff estimates.

Option 1: Increased Budget Authority and Outlays for U.S. Non-Military Foreign Assistance and Credit Programs

The Congress could appropriate increased budget authority for on-budget foreign assistance and credit programs. The most likely candidates for such an expansion would be Security Supporting Assistance (SA), bilateral development assistance, and multi-lateral development assistance.

Increasing foreign assistance and Eximbank credits could be considered attractive since:

- The United States has full control over bilateral programs and could therefore target foreign assistance to countries either most likely to spend incremental funds on imports of goods and services or most in need of financing to avoid over-rapid adjustment. (Such control would be more diluted in the case of increased contributions of paid-in capital to multilateral development banks (MDBs). In the MDBs, the United States has only the "influence" accruing to a major shareholder.)

- Virtually all funds provided to recipients under the foreign assistance programs go to non-oil LDCs or (in the case of SA and multilateral assistance) to non-oil Mediterranean countries. More than two-thirds of Eximbank's five-to-twelve-year lending also goes to such countries at the present time.[5/]

5/ Derived from U.S. Export-Import Bank, "Supplement to the 1976 Annual Report: Authorizations by Country," (July 1, 1975 - June 30, 1976) p. 15.

Increasing foreign assistance or Eximbank credits could also have drawbacks as a policy for world stimulus and stabilization:

- o As a result of statutory provisions which largely tie U.S. bilateral (although not multilateral) foreign assistance and credits to the purchase of U.S. goods and services, a substantial, unilateral increase in such programs could cause the United States unwanted diplomatic difficulties. If U.S. assistance is tied to the purchases of U.S. goods and these purchases are perceived by competing exporters as diverting trade from them (as opposed to being "additional" to recipients' "normal" imports), other exporting countries might object.

- o An increase in budget authority for the on-budget programs <u>which actually lead to outlays</u> (as opposed to guarantees or callable capital, which normally do not), would necessarily increase the size of the expected federal budget deficit as budget authority led to outlays.

- o With the notable exception of Security Supporting Assistance--a program which is able to extend loans and grants for commodity imports and balance-of-payments support (so-called "program" as opposed to "project" loans)--and of P.L. 480, all existing foreign assistance and Eximbank's credit programs "spend out"on real goods and services at an exceedingly slow rate. Major increases in budget authority would be required for these latter programs to serve stabilization objectives in the near term. Historical rates suggest that only in the case of SA and P.L. 480 will as much as three-quarters of budget authority appropriated for fiscal year 1978 actually lead to expenditures on real goods and services by the end of fiscal year 1979 (September, 1979).6/

o Major increases in budget authority and outlays would be called for in order for there to be a significant impact on the future growth of even some of the oil-importing countries. The World Bank has estimated that it would require an additional $2 billion per year to increase the growth rate of ten of the poorest LDCs (those with less than $200 per capita annual income) by 2.5 percentage points per year.7/ To achieve a $2 billion cumulative (not annual) increase in outlays by 1980, bilateral development assistance, multilateral development assistance, and Eximbank loans might require an increase in Budget Authority for fiscal year 1978 of some $4 billion.

6/ CBO estimate.

7/ The ten are India, Pakistan, Bangladesh, Sri Lanka, Kenya, Tanzania, Uganda, Ethiopia, Mali, and Sudan. See, N. L. Hicks, "A Model of Trade and Growth for the Developing World," European Economic Review, 7, (1976), p. 250.

Debt Relief. Some of the disadvantages of expanding on-budget programs could be overcome by rescheduling or cancelling some debt service payments due to U.S. government agencies from deficit, debtor countries. The Congress could urge the executive agencies to provide debt relief to weaker OECD or non-oil LDC economies on either a general or selective, bilateral or multilateral basis.

Debt relief would immediately increase net outlays by an amount equal to the required increase in budget authority. Such an initiative would immediately increase the capacity to import of debtor countries.

No convincing case has been made that all LDC or weaker OECD economies would immediately use funds freed by the suspension of debt repayments on imports. A generalized debt moratorium, such as that requested by some LDC members of UNCTAD, may not be the most appropriate tool for international economic stimulus. Still, debt relief aimed at rapidly stimulating the world economy might be effective if it were limited to countries with very high debt-service-to-export ratios or to countries whose foreign exchange reserves are a particularly small fraction of imports--much as domestic tax cuts granted to poorer people who are likely to spend additional income may provide a quicker and surer stimulus than do cuts to high-income people who are likely to save additional income. Selective debt relief could also serve "liquidity-crisis-avoidance" stabilization objectives.

In the past, the U.S. Treasury and other creditor agencies have been extremely reluctant to reschedule or suspend debt service payments of debtor countries. Debt rescheduling has been limited to extreme cases partly because of Congressional concern about "backdoor spending" by the Treasury, about the financial soundness of the Export-Import Bank, and about possible complaints of inequitable treatment were the debts of only some countries to be rescheduled. A historical precedent does exist for a different policy, however. The United States did not press for collection of all the debts of its World War II allies--on the grounds that such repayments would have inhibited both European reconstruction and the recovery of the world economy from World War II.[8/]

In fiscal year 1977, foreign debt service payments (on non-military accounts only) to the U.S. government and its agencies are expected to total some $3.2 billion: $505 million of this for repayments of foreign assistance loans, over $2 billion in payments of interest and repayment of principal to the Export-Import Bank, $218 million for P.L. 480, and $539 million under the Short-Term Export Credit Sales Program.[9/] The majority of these repayments are to be made by non-oil LDCs.

8/ Raymond Ahearn, "A Survey of Foreign Indebtedness to the United States," Congressional Research Service, Library of Congress, (April 21, 1976).

9/ CBO estimate.

Option 2: Guarantees for Private Sector Financing

At least two possible U.S. government--or multilateral--measures could be envisaged to maintain, increase, or channel the flow of private financial resources directly to the less resilient OECD and non-oil less developed countries: an expansion of guarantees and insurance by the Export-Import Bank, Overseas Private Investment Corporation (OPIC), or other U.S. or multilateral institutions of private loans and investments, and the establishment of an international resources bank.

Callable capital guarantees could also be increased for backing multilateral development bank borrowing from the private sector. The Congress has in fact appropriated an increase of about $800 million in MDB callable capital for fiscal year 1978.[10/] Such backing guarantees the repayment to the private sector of the funds that private lenders supply to these institutions. The MDBs in turn lend these funds on to LDC borrowers.

Guarantee and insurance programs give rise to U.S. government outlays only in rare cases of default by foreign borrowers, instances of currency convertibility, or expropriation of U.S. foreign investment. An increase in Eximbank guarantee and insurance authorizations and in AID's housing guarantee authority would require a further increase in budget authority.

[10/] Foreign Assistance and Related Programs, Appropriations for Fiscal 1978, (P.L. 95-148).

Offering the private sector an increase in the amount of guarantees available would provide no necessary assurance that those guarantees would be used. It is more certain that MDB callable capital would lead to increased MDB borrowing. If guarantees were used, however, there would be no necessary assurance that they would cause incremental funds either to flow at all, to flow soon, or to flow to those foreign countries that would be most likely to increase their overall imports. Increased MDB borrowing based on callable capital would almost certainly spend out or loan out to LDC borrowers at the same very slow rate as paid-in capital. A $2 billion increase in MDB callable capital in fiscal year 1978 is likely to lead to a cumulative increase of only $1 billion in loan disbursements by the end of calendar year 1980.[11/]

Augmenting guarantees of private sector lending or investment could be criticized on the grounds that guarantees extended on an across-the-board basis would be a very inefficient way of channeling funds to the particular countries with the most pressing problems of financing imports, and therefore would not usefully address the problem of stabilization. Since increasing investment in energy conservation and oil exploration in any non-OPEC country would help all non-OPEC countries by reducing the OPEC surplus, a policy which would increase guarantees (or insurance) for such

11/ Derived from CBO spendout estimates.

specific purposes could be defended as a potential contribution to stimulating the world economy.[12/]

Guarantees of private-sector financing of deficit countries have been criticized as a potential "bail-out" of private commercial banks and lenders for their mistakes in lending to uncreditworthy countries in the first place. A counter to this criticism would be that guarantees which do not lead to outlays--or which outlay only in extraordinary circumstances--are much less costly of taxpayers' money (if not less costly in terms of resources diverted from the domestic economy) than are foreign assistance loans or grants. If one were to posit the possibility of an unprecedented rate of default of 10 percent, the Congress could authorize $20 billion of guarantees before there would be an impact on outlays commensurate with a $2 billion increase in on-budget spending or debt-relief programs. Moreover, defaults on medium- and long-term (i.e., 3-to-12-year) loans would be most improbable during the very near term, and, therefore, would be of little importance to the budget before 1981.

An international resources bank (IRB) could also be established on a multi-lateral or bilateral basis to promote financial and technological flows from the private sector to (some) deficit countries. The fund for financing an IRB (as proposed by the Ford Administration) was estimated at $1 billion--$200 million

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[12/] Whether such guarantees would provide a real contribution would depend on whether the projects for which they were extended would have been undertaken without guarantees in any event.

of which would have been a U.S. contribution, probably in the form of callable capital.[13/] An IRB (or an American resources bank) could contribute to the resolution of some deficit countries' adjustment problems if it provided guarantees or financing not so much of mineral exploration and development in LDCs and weaker OECD countries, but rather of oil, coal, shale, and other energy sources that would provide alternatives to imports of OPEC oil. Since such an IRB could only channel funds to countries which had the geological good fortune to have (potential) energy sources, it could not be envisaged as a solution to the problem of stabilization.

Option 3: The OECD Financial Support Fund (or "Safety Net")

In June of 1975, the Ford Administration sent to the Congress a proposal for the establishment of a Financial Support Fund (FSF).[14/] The proposed fund would have a membership limited to the 25 OECD member countries; as a multi-lateral institution, it would provide a means of sharing both the burden and the control over the international financial flows with other nations. As initially proposed, the FSF would have a total subscribed capital of $25 billion. In 1975, all OECD countries, except Turkey, gave

13/ Congressional Budget Office, Commodity Initiatives of Less Developed Countries, U.S. Responses and Costs, Background Paper (May 1977), p. 1, footnote.

14/ "United States Participation in the Financial Support Fund," Communication from the President of the United States, House Document 94-178, (June 6, 1975).

27-039 O - 78 - 21

their agreements to the establishment of the FSF--subject to legislative ratification.[15/]

The U.S. share of the FSF was proposed at some $7 billion; this amount was to be contributed not only by an on-budget expenditure of taxpayers' money, but also by the authorization of guarantees of "callable capital," which would pledge the full faith and credit of the U.S. government behind FSF borrowings in private capital markets. The combined German and Japanese share of FSF guarantees would slightly exceed that of the United States.

The FSF represents one possible response to the possible risk of political, adjustment, or liquidity crises in one or a handful of countries. As its nickname "Safety Net" implies, the FSF conceived of as a means to cope with the problem of stabilization, not that of stimulus.

The proposed Articles of Agreement of the FSF proposed that borrowers be required to follow "adequate balance of payments policies and cooperative policies to promote increased production and conservation of energy."[16/]

As an off-budget fund, to be financed only under a U.S. guarantee (except in the extreme case of borrower default), the FSF would not be expected to require budgetary outlays and would, therefore, not have the impact on the federal deficit that an

15/ Ibid., p. 6.

16/ Ibid., Appendix, Proposed Articles of Agreement, OECD Financial Support Fund, Article 1, Sec. 2(a)(ii).

expansion of on-budget loan or assistance programs would have. Approval of the FSF by the Congress might therefore require only authorization, not appropriations. The lack of an effect on outlays for the FSF would be the same whether or not the callable capital guarantee for the establishment of the FSF was appropriated and included in budget authority, or whether it was merely authorized.

The FSF proposal has been criticized on the grounds that it would not provide access to some of the countries likely to have the highest risk of crisis, the middle- and lower-income, non-oil LDCs.

Option 4: An Expansion of the International Monetary Fund

The United States may wish to stimulate the world economy by increasing the total flow of private or public financial resources to deficit countries. The United States may also wish to take both a security and a humanitarian interest in preventing political turmoil in countries--such as Italy, Britain, Egypt, Mexico, Jamaica, Peru, or Zaire--trying to adjust to post-1973 relative prices, to obtain enough foreign exchange to avoid excessively rapid adjustment, or to tolerate low, zero, or negative growth. Expanding the resources available to the IMF could provide a single means toward achievement of both the stabilization and stimulus objectives.

If funds or guarantees targeted at particular countries (or groups of countries such as the OECD) are to be used to avoid crises, the loci of probable crises must be known in advance. However, one would need to undertake a country-by-country analysis and prediction of risk, and even then, one could not be terribly sure. The very difficulty of making such predictions suggests that the most pressing need may be for a flexible, normally revolving fund that would operate in the interstices between national and international, short-term monetary instruments (like the Treasury Department's Exchange Stabilization Fund and Federal Reserve Swap Loans), and long-term development instruments (such as public assistance and private investment). Since the IMF already performs many of the functions that might be required of such a fund, the requisite instrument could simply be an expanded IMF.

It could be argued that an appropriate fund would have to be accessible to the LDCs, and particularly to LDCs that are (or might become) "uncreditworthy," and not just to OECD countries, as would be the proposed Financial Support Fund or "Safety Net." Such a fund might be called upon to lend rather large amounts of money on a medium-term (i.e., one-to-five-year) basis; it would therefore have to be of a size and legal structure adequate to the task.[17/] If Egypt, Mexico, Zaire, and Portugal--not to mention the United Kingdom and Italy--are relevant examples, a handful

[17/] The IMF, to be sure, already lends on terms up to five years. The new Extended Fund Facility (EFF)--thus far used by Mexico, the Phillippines, and Kenya--provides loans for even longer periods, as did the now defunct IMF Oil Facility. Up to December 31, 1976, only some $100 million had been borrowed under the EFF.

of such structural transformations would rather rapidly deplete the IMF's current estimated $2 billion of available and uncommitted currencies.[18/] In 1976, Mexico requested $962 million from the IMF.[19/] Four such incidents would require an IMF with double the present size of the IMF's resources. An IMF with a capability to finance an increase of 2 percent in (noncommunist) world trade would need some $17 billion in incremental resources in 1977.[20/] Calculations undertaken with the Wharton School "LINK" model in 1977 suggest that such an amount of annual financing, if directed toward deficit LDCs, might increase LDC annual growth rates by nearly 1.5 percentage points and OECD average growth rates by nearly 0.5 percentage points.[21/]

Such a fund might be better able to attack the illness, rather than just temporarily mask the symptoms, if it were able to insist on conditionality of a kind that would encourage investment in agriculture (especially in LDCs dependent on imported grain), in energy conservation, or in finding and developing alternative fuel sources and which would encourage investment that would

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18/ IMF staff estimate (June 1977).

19/ Samuelson, National Journal (February 26, 1977), p. 325.

20/ International Trade 1975/76, General Agreement on Tariffs and Trade [GATT], (Geneva, 1976).

21/ Derived from CBO spendout estimates.

have a relatively short gestation period. (The still tiny Extended Fund Facility of the IMF would appear to provide a prototype of such a fund. The EFF provides six-to-eight-year loans to countries conditioned on presentation of a "plan for structural transformation." EFF loans have so far totaled slightly more than $300 million.)[22/]

An IMF expanded along these lines would no longer operate only as a monetary instrument. The Fund would have to assess not only borrowers' progress toward effecting international adjustment by setting macroeconomic targets--as the IMF does in the case of normal borrowings--but also their progress in making domestic sectoral adjustments.

Expanding the resources of the IMF could be done by several means, the most likely of which might include either a further increase in members' quotas or the re-creation of an arrangement to the now defunct Oil Facility.[23/] Participation in these arrangements would require authorization; whether or not participation would be subject to the appropriations process is uncertain.

[22/] The International Monetary Fund, International Financial Statistics, (August 1977), page 12.

[23/] In 1974 and 1975, immediately following the quadrupling of oil prices, the IMF ran a so-called "Oil Facility" that acted as a direct intermediary between OPEC and industrialized countries with current borrowers (such as the United Kingdom, Italy, and Spain). During the two years of its existence, the OPEC countries provided nearly $6 billion and the "strong" surplus industrialized countries provided some $2 billion in resources to the Oil Facility for five-to-seven-year terms at a rate of 7 percent interest. The resources were lent out to borrowers--without

(continued)

The United States has already contributed to one measure that will increase the resources available to the IMF. In October 1976, the Congress approved the revised Articles of Agreement of the International Monetary Fund.[24/] This approval included authorization of a U.S. subscription to a 30 percent increase in IMF quotas that (conditional on other member countries' approval) is expected to take place during 1978. This increase in quotas will augment available, uncommitted currencies not only by the 30 percent of the quota increase, but also by some $1 billion of convertable currencies to be contributed by OPEC countries as a *quid pro quo* for an expansion of their voting power in the IMF. Available resources of the IMF will be increased by these measures to some $3.6 billion.

Nevertheless, there has been a growing recognition that even after this increase takes effect, the resources of the IMF might

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23/ (continued from previous page) conditionality--for terms of five to seven years at just over 7 percent interest. Access to the Facility was based on the degree to which a borrowing country's bills for oil imports had increased. The Oil Facility is currently inoperative. It is alleged that it became defunct because the interest rates it was offering became unattractive to OPEC leaders. Apparently, the reluctance of certain developed, industrial countries to see "too much OPEC influence" in the IMF also contributed to the demise of the Oil Facility.

24/ P.L. 94-564, Bretton Woods Act Amendments, October 19, 1976, U.S. Congressional and Administrative News, (1976), 90 Stat., p. 2660.

prove to be inadequate to meet the requirements for balance of payments financing over the next few years. The solution to this problem is usually thought to lie in a further permanent increase in Fund resources brought about by still another increase in quotas. Unfortunately, this is expected to be a time-consuming process. The next quota review will begin in 1978, and new quotas are not expected to be agreed to until late 1979 or 1980. In the meantime, some temporary supplementary facility may be required to make increased resources available immediately.

A revived IMF Oil Facility would, in some ways, be the most efficient of all possible instruments for promoting a rationally distributed flow of financial resources from OPEC and trilateral surplus countries to deficit countries. A revival of the Oil Facility would require only a vote of the managing board of the IMF.[25] Instead of surplus funds transiting by the convoluted intermediation of several private and public agencies, a revived Oil Facility could, in one step of intermediation, obtain funds from surplus countries and loan them for medium-period terms to the deficit countries experiencing a capacity-to-import constraint to growth. A revived Oil Facility could give the IMF resources it would need to act both as an instrument for "recycling" finance in the interest of world recovery and as a lender of last resort to prevent crises.

25/ Borrowers had access to the original Oil Facility in proportion to the degree to which their oil import bills had increased. A revived Facility would not necessarily have to operate under such a restriction.

One recent proposal along these lines is that put forward by IMF's Managing Director H. Johannes Witteveen. Tentative resource commitments to the Facility amount to about $10 billion, roughly half from OPEC nations and half from industrialized nations. The United States contribution to the total is tentatively set at $1.7 billion.[26/]

To meet the perceived need for a temporary increase in Fund resources, the Executive Directors of the Fund established, in August 1977, a Supplementary Financing Facility. This new facility, more commonly called the Witteveen Facility, will provide an additional 8.7 billion Special Drawing Rights (SDR)--about $10.5 billion--to the resources of the IMF. Fourteen member countries have agreed to make resources available for this facility, and one other country is expected to make a contribution. Roughly half of the resources will be supplied by oil exporting countries, with the remainder supplied by the stronger industrial countries.

The resources made available for the Witteveen Facility will be lent to the IMF. In turn, the IMF will lend them to member countries in need of balance of payments financing. Use of the facility will be open to all Fund members. The maturity of loans extended by the facility will be from three to seven years.

26/ Congressional Budget Office, International Balance of Payments to Financing and the Budget Process, Staff Working Paper (August 1977), p. 20.

Borrowing countries will pay a "market-related" rate of interest, and the Fund will pay a similar rate to the suppliers of the resources.

The proposed facility resembles, in some respects, the Oil Facility operated by the IMF during 1974 and 1975. The resources of the Oil Facility were borrowed by the Fund from oil-exporting and industrialized nations in the same way that the resources for the Witteveen Facility are to be borrowed. The major differences between the Oil Facility and the Witteveen Facility, however, lie in the purposes of and the conditions associated with lending provided by the two facilities. The Oil Facility, in which the United States did not participate, was intended to provide financing for member countries whose balance of payments positions suffered because of increased oil prices. It was intended as a temporary measure to help countries during an unusually difficult period, and as such it provided loans with few conditions attached to them. In contrast, the Witteveen Facility is intended to facilitate the adjustment by member countries to what are perceived to be permanent changes in the world economy. Funds from the facility, therefore, will be available only in conjunction with drawings from the permanent facilities of the Fund and will carry the same conditions as drawings from permanent facilities of the Fund.

U.S. participation in the proposed facility, which would be governed by provisions in the decision numbered 5509-(77/127) of the Fund, would involve making available to the IMF the dollar equivalent of 1.45 billion SDRs (about $1.75 billion). The IMF would draw upon these funds, if and when needed, to meet withdrawals by member countries from the facility. Funds actually drawn by the IMF will earn interest at a rate equal to the yield on U.S. Treasury securities of comparable maturity. In exchange for funds provided to the facility, the U.S. will receive a reserve claim on the IMF, which may be redeemed upon the demonstration of balance of payments need or may be sold to other members of the IMF. U.S. participation in the Supplementary Facility would require authorization by the U.S. Congress. It is uncertain whether participation would be subject to the appropriations process.

Establishment of such a facility might require a quid pro quo to OPEC and trilateral surplus countries in the form of a greater voice in managing the IMF.

The Congress could urge the Executive to increase the resources at the disposal of the IMF. As a practical matter, however, the Executive would have to initiate negotiations aimed at increasing IMF resources with other member countries. The managing board of the IMF is scheduled to begin a review of the adequacy of quota subscriptions in 1977-78. However, it could still take two or three years for the preparation of a U.S. initiative for a quota increase, for its negotiation, and for its approval by the Congress and other IMF member countries' legislatures.

ANNEX

PRINCIPAL U.S. PROGRAMS WHICH PROVIDE, FACILITATE, OR GUARANTEE THE FLOW OF FINANCIAL RESOURCES TO FOREIGN COUNTRIES, INDICATORS OF FISCAL YEAR 1977 SIZE OF PROGRAM, AND APPROXIMATE PERCENTAGE OF NET FLOWS DESTINED TO GERMANY AND JAPAN, OPEC COUNTRIES, "OTHER OECD", AND NON-OIL LDCS, IN BILLIONS OF DOLLARS

Program	Size As Indicated By:	Approximate Percentage of Net Flow Destined For: Germany and Japan	OPEC	Other OECD	Non-Oil LDCs	Unallocable Administrative Or Other	Total Percentage
I. On-budget spending programs	Fiscal Year 1977 Net Outlays						
A. International Affairs (150) Function							
Bilateral Development Assistance	$1.1	0	4	0	96	--	100
Multilateral Development Assistance	1.1	0	9	6	85	--	100
P. L. 480	0.8	0	8	8	84	--	100
Security Supporting Assistance	1.2	0	0	4	96	--	100
Export-Import Bank Loans	0.5	5	10	26	53	6	100 a/
Conduct of Foreign Policy	1.3	Not distributable					
Undistributed offsetting receipts, and other)	-0.6						
Subtotal, 150 Function	5.4						
B. Other Functions							
Foreign Military Credit Sales (050)	0.3	0	1	18	81	--	100
Foreign Military Assistance (050)	0.3	0	4	44	30	22	100
CCC Short-term Export Credits (350)	0.5	0	?	?	(90)	--	100
Total, On-Budget Programs	6.5						

II. Tax Expenditures and Foreign Tax Credit	Estimated Fiscal Year 1977 Revenue Foregone by U.S. Government						
Deferral of Foreign Source Income b/	0.4			Unknown			
DISC b/	1.4			Not distributable			
Foreign Tax Credit b/	4.0			Not distributable			
Total	5.8						
III. Off-budget Programs	Estimated (Net) Lending & Credit Extended Calendar Year 1976						
A. U.S. Programs							
Exchange Stabilization Fund	2.0			Unknown			100
Federal Reserve Swap Loans	0.3	0	0	69	31	-	100
Federal Financing Bank Military Credits	1.5	0	0	-----100------		-	100
B. Multilateral Programs with U.S. Support							
IMF		0	0	70	30	-	100
General Agreements to Borrow	2.1 c/	0	0	100	0	-	100
Total	5.9						
IV. Guarantees and Insurance	Amount Extended Fiscal Year 1976						
Export-Import Bank	5.1	5	16	31	48	1 d/	100
Multilateral Development Bank Callable Capital (Increase provided by U.S.)	0.4	0	9	6	85	-	100
AID Housing Guarantees	0.2	0	0	0	100	-	100
OPIC (Private Investment)	1.2	0	10	10	80	-	100
Total	6.9						

a/ Based on Eximbank authorizations by country, July 1, 1975 through June 30, 1976.

b/ U.S. Treasury estimate. This measure may not be a good indication of the amount of funds U.S. firms would repatriate from abroad were the tax credit to be removed. Corporate financial decisions depend on many factors other than tax rates. Removal of the tax credit without eliminating deferral would almost certainly decrease remittances of taxable income from abroad by U.S. firms.

c/ Calculated as the U.S. contribution of $8.4 billion divided by the four-year average term of IMF/GAB loans.

d/ Calculated by the Export-Import Bank and based on fiscal year 1976 authorizations for guarantees and insurance.